FEDERAL INCOME TAX PROBLEMS - 1922

E. E. ROSSMOORE

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FEDERAL INCOME TAX PROBLEMS—1922

BY

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REFERENCES, ABBREVIATIONS, ETC.

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The bulletins referred to are the Internal Revenue Bulletins, issued weekly, and obtainable from the Government Printing Office, Washington, D. C. Regulations 45 Revised are the regulations relating to the income tax and war-profits and excess-profits tax under the Revenue Act of 1918. Regulations 62 relate to similar taxes under the Revenue Act of 1921.

The following abbreviations are used:

A. R. M.	Committee on Appeals and Review Memorandum.
A. R. R.	Committee on Appeals and Review Recommendation.
Bul.	Internal Revenue Bulletin.
C. B.	Cumulative Bulletin.
L. O. (or O.)	Solicitor's Law Opinion.
O. (or L. O.)	Solicitor's Law Opinion.
O. D.	Office Decision.
Reg.	Regulations.
Rev.	Revised.
S.	Solicitor's Memorandum.
Sol. Op.	Solicitor's Opinion.
T. B. M.	Advisory Tax Board Memorandum.
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PREFACE

The present Congress has achieved the seemingly impossible task of passing an income-tax law even more complicated than its already far too complicated predecessor. And so the taxpayer finds himself confronted with the task of meeting the requirements of a statute that even the expert will have difficulty in unravelling.

Whether or not he is interested in the law and all its ramifications, the taxpayer must of necessity obtain a very thorough knowledge of those parts that apply to his own case. But the average taxpayer has no time to pore over the act in its entirety, to decipher each section, and then to be left wondering whether any particular section applies to his own tax return. He has several very definite questions to ask and he wants very definite answers—authoritative answers on which he can rely. It was with a view to the meeting of this situation that the present work was undertaken.

After careful consideration the author has departed from the more familiar method of presentation by means of general statements, and has instead analyzed the subject into a series of concrete and representative problems. Because he has adhered so closely to the problem method the writer feels that it would not be amiss to point out and emphasize what he considers to be its advantages over the other, more usual method.

There is an inherent difficulty in treating a complex subject by means of general statements, for the reason that a statement which is at once general and accurate tends to become so cluttered up with reservations as to make it unintelligible to any but the expert. And if the reservations are omitted in order to make the essential idea easier to grasp, the resultant loss of accuracy renders the statement unreliable. A general statement can be at best only a paraphrase of the law itself and, like the law, must be interpreted. If the paraphrase is short

it loses in accuracy and clearness; if it is expanded, the reader requires even more time to go through it than through the original law. Even if these obstacles are surmounted, the reader is still confronted with the necessity of applying the general knowledge gained to the specific problem at hand.

The problem method, it seems to the writer, avoids these disadvantages and lends itself more readily to the simple exposition of a complex subject. Many of the various questions that arise in practice are here tabulated, the circumstances under which they arise are concisely stated, and a specific answer to each question is given so that the reader who is not himself a legal expert can obtain authoritative directions as to the proper method of procedure. The problems are arranged and indexed so that the reader can turn at once to the group in which he is interested. If the first problem is the same as his, he recognizes it immediately; if it is not, it is hoped that he will need to run through only a small group to find what he wishes. The answers do not conclude the problems, but in each case there is in addition a statement of the authority upon which the answer is based. Moreover, in certain instances where there is a reasonable doubt as to the meaning of the statute, a discussion of the author's interpretation has been added. The reader who is not satisfied with a categorical reply but who desires to go further into the subject will find in these references and discussions material for further inquiry and research.

In advocating the problem method the author feels that he has the support of modern educational experts in other fields. In fact this method is a characteristic mark of present-day pedagogy. In our law schools the lecture method of presentation has given way largely to presentation by cases; in schools of medicine and engineering the modern student is taught not so much by means of lectures as by the far more practical and efficient means of actual work in the laboratory. Even in theoretical science and in pure mathematics, teaching is carried on very largely by means of problems. In all these cases the question is put first and it is not until the student

has mastered the solution that he is given a general summing up, with the result that the general statements become full of meaning instead of hollow generalities waiting to be filled in with concrete data.

This mode of exposition is all the more effective in the presentation of the income-tax law because a strictly logical arrangement is in the nature of the case impossible, since the law itself is not a structure of logical sequence. It was, as is well known, hastily put together; its different parts were suggested by various persons each with his own theory of taxation; and the result represents a compromise on the basis of expediency rather than of logic. So faulty is the law that even its sponsors admit its shortcomings. The late Senator Penrose, who introduced the bill into the Upper House of Congress, characterized it as "a temporary makeshift" which "does not place the tax system on a stable and scientific basis." The author believes it best, therefore, to consider each important point of the act as a specific problem in itself.

A feature of the book to which the author wishes to call special attention is the double system of indexing. In addition to the general index a special index has been compiled for those more particularly interested in the legal aspects of the revenue act.

It is hoped that if the method and the arrangement of the book succeed in simplifying for the business man a complicated subject, the same qualities may render the work useful to the student and teacher. It is believed that a class that has acquainted itself with the problems and mastered their solutions will have a knowledge analogous to that gained in actual business experience.

The book was begun when the revenue bill was first introduced into Congress and the author has attempted to keep pace with the development of the law. He has tried to keep in touch with the progress of the bill throughout all the hearings, committee sittings and debates until its adoption in its present form. He has gone through the completed act with the utmost care, comparing it with the act of 1918, and working out its

applications to actual problems that will arise in the various types of business. In his research on the subject he has had the assistance of a corps of experts whose investigations have supplemented his own. With the aid of these experts all the problems in the book have been carefully worked out so that their formulation is as precise as possible; and the solutions and references have been thoroughly checked.

The author wishes to express his appreciation of the assistance rendered by the members of his staff. In particular does he wish to acknowledge his thanks to Mr. H. D. Heiby and Mr. H. O. Walker without whose co-operation this work could not have been completed.

E. E. Rossmoore.

17 East 42nd Street,
New York, N. Y.
March 15, 1922.

INTRODUCTION

To those acquainted with the Revenue Act of 1918, a book on the subject of the Revenue Act of 1921, would not be complete without a comparison of the Revenue Act of 1921 with the Revenue Act of 1918.

Accordingly the following are pointed out as the more important and interesting changes made in the 1921 Revenue Act from the 1918 Act with respect to the income tax and the excess-profits tax. These changes were made by the 67th Congress in an effort to alleviate the burdens of abnormal taxation and at the same time provide sufficient revenue to meet the requirements of the Government. The Revenue Act of 1921 was therefore captioned "An Act to Reduce and Equalize Taxation, to Provide Revenue, and for Other Purposes." To what extent Congress has succeeded in its first object, namely, to reduce and to equalize taxation, may be noted by following the changes in the new law; to what extent Congress has succeeded in accomplishing its second object, namely, to provide revenue, will be seen only when all the returns are filed and the taxes due thereon are collected.

In referring to the more important and interesting changes effected by the Revenue Act of 1921, these changes may be classified under the following:

1. Changes to reduce taxation.
2. Changes to remove certain inequities existing in the Revenue Act of 1918.
3. Changes to prevent the evasion of taxation.
4. Miscellaneous changes.

1. Changes to Reduce Taxation.

The normal-tax rates and the surtax rates applying to individuals up to and including December 31, 1921, remain unchanged, that is, these rates are the same as provided for in

the Revenue Act of 1918. Beginning, however, with January 1, 1922, the surtax rates are somewhat reduced, particularly for those whose incomes are in excess of $100,000.

In the case of individuals for the purpose of computing the normal tax the personal exemption for a married person living with husband or wife has been increased to $2,500, except where the net income is in excess of $5,000, in which case the personal exemption is $2,000 (the same as in the Revenue Act of 1918). In no case, however, is the reduction of the exemption from $2,500 to $2,000 permitted to increase the tax above an amount equal to the tax which would be payable if computed with a $2,500 exemption, plus the excess of the net income over $5,000.

The exemptions allowed individuals because of dependents have been increased from $200 to $400 on account of each dependent.

The excess-profits tax prevailing under the Revenue Act of 1918 and applying to corporations, is continued and effective to and including December 31, 1921, at the same rates as prevailed during 1919 and 1920. However, beginning with January 1, 1922, there is no excess-profits tax. The ordinary income tax of 10% applying to corporations under the Revenue Act of 1918, is increased to 12½% effective January 1, 1922.

2. Changes to Remove Certain Inequities Existing in the Revenue Act of 1918.

A provision of the Revenue Act of 1921 of considerable interest and benefit to taxpayers is covered by section 206, which provides for a limited tax on profits resulting from the sale of capital assets. A capital asset is defined as property acquired and held by the taxpayer for profit or investment for more than two years. Section 206 provides that where a taxpayer has capital net gain as the result of the sale of capital assets after December 31, 1921, he may compute the tax on such capital net gain by taking 12½% thereof (in lieu of the tax computed by the usual method), provided, however, that the total tax on the taxpayer's net income is not less than

12½% of his total net income. This option should be effective in encouraging the sale of capital assets held by individuals who would otherwise be subject to excessive taxation on any profits realized by such sale.

Another provision of particular interest and benefit to taxpayers, both individuals and corporations, is that contained in section 204, with reference to net losses. The "net loss" under the statute is not what would perhaps ordinarily be regarded as a net loss, but consists of a loss arising out of the operations of the trade or business regularly carried on by the taxpayer and is computed by deducting certain specified items from certain other specified items. The statute provides that net losses for any taxable year beginning after December 31, 1920, or for such portion of a taxable year beginning in 1920 and ending in 1921 as is applicable to 1921, are deductible from net income for the succeeding taxable year to the extent of such net income. The excess, if any, of such net loss over such net income of the succeeding taxable year is deductible from the net income of the next succeeding taxable year up to the extent of the net income of such next succeeding year. This provision is a real approach towards equity in income taxation.

Another provision of considerable interest and benefit to taxpayers, both individuals and corporations, is that contained in section 202, with respect to the computation of the gain or loss sustained from the sale or other disposition of property. Of particular interest are those provisions which follow the decision laid down by the Supreme Court in the Goodrich case applying to the sale of property acquired prior to March 1, 1913, in accordance with which, in the event of profit, such profit is taxable only to the extent that it accrued since February 28, 1913, and in the event of a loss such loss is deductible only to the extent that it accrued since February 28, 1913. Another provision of this section of the law does away with "paper" profits or losses arising out of the exchange of one form of property for another. Thus, in an exchange of one form of property for another no gain or loss is recognized unless the property received in exchange has a readily realizable

market value, and even if the property received in exchange has a readily realizable market value, no gain or loss is recognized if any such property held for investment or for productive use in the trade or business is exchanged for property of like kind or use, or if, in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation, a party to or resulting from such reorganization. This provision will permit corporations to enter into reorganizations, consolidations or mergers, without fear of such transactions resulting in unjust taxation of "paper" profits.

Of interest and benefit to probably only a relatively small class of taxpayers are the provisions contained in section 262. This section applies to citizens of the United States or domestic corporations 80% or more of whose gross income for the three-year period immediately preceding the close of the taxable year, was derived from sources within a possession of the United States, and 50% or more of whose gross income for such period was derived from the active conduct of business within a possession of the United States. Such citizens or domestic corporations are taxable only on their gross income from sources within the United States unless income derived from sources within a possession of the United States or from sources within a foreign country is actually received by such citizens or corporations within the United States, in which case such income is also taxable. This provision is intended to relieve taxpayers conducting business within a possession of the United States from double taxation, and to permit them to compete on fair terms with the citizens of other countries doing business within such possessions.

Of some interest and benefit is the provision contained in section 214, permitting the deduction from gross income of traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business. The practice of the Bureau of Internal Revenue under the Revenue Act of 1918 was to allow as a deduction only that part of traveling expenses which represented

the increase in cost as a result of traveling over the cost of subsistence at home.

Of very considerable interest and advantage is the provision contained in the new law (and it applies both to corporations and to individuals) with respect to the deductibility of bad debts. Debts ascertained to be worthless and charged off within a taxable year are deductible from gross income as in previous income-tax acts. However, under the 1921 Act the Commissioner is authorized to permit the deduction from gross income of a bad debt charged off in part where the Commissioner is satisfied that such debt is recoverable only in part. The Commissioner is also authorized, in his discretion, to permit a deduction from gross income on the basis of the creation of a reserve for bad debts. However, under Treasury Decision 3262, recently issued, such reserve for bad debts may be set up only in a reasonable amount and after a taxpayer has elected this method of providing for bad debts he is required to continue that method unless permission to change is granted by the Commissioner. Under Art. 155, Regulations 62, more recently issued, a taxpayer is permitted, if choosing to take his deduction on the basis of the reserve set up, to deduct also that part of the total charge to the reserve account in any taxable year which applies to debts outstanding December 31, 1920. The provision of the Revenue Act of 1921 permitting the charging off of bad debts in part or the setting up of a reserve for bad debts and the deduction from taxable income of the amount so charged off or reserved brings the income-tax procedure more into conformity with sound business and accounting practice.

Authority to take deductions from gross income on account of contributions is extended to include contributions or gifts made for the use of the United States, any State, Territory or subdivision thereof, or the District of Columbia, for exclusively public purposes. The total amount of contributions allowable as a deduction from gross income is, however, as heretofore, not to exceed 15% of the net income arrived at before taking contributions or gifts as a deduction.

Section 250 provides that where an undue hardship would result from the necessity of making immediate payment on account of assessment of additional taxes due under the Revenue Acts of 1917, 1918 and 1921, the Commissioner may extend the time of payment of such tax for a period not exceeding 18 months from November 23, 1921. Other parts of section 250 provide for the definite closing of tax cases. Provision is also made to relieve taxpayers of the frequent and unnecessary re-examinations of returns which in the past have been permitted.

The Revenue Act of 1918 provided that losses were deductible only for the year in which sustained. The Revenue Act of 1921 continues this provision but further provides that in exceptional circumstances, in order to avoid injustice to the taxpayer and to more clearly reflect his income, the Commissioner may permit a loss to be accounted for as of a year other than the one in which sustained.

The Revenue Act of 1921 provides that in case property is compulsorily or involuntarily converted into cash or its equivalent under certain circumstances, the proceeds of such conversion would not be taxable or would be taxable only in part, even though ordinarily such conversion would be regarded as resulting in a profit. This rule applies where the taxpayer proceeds forthwith in good faith to expend the proceeds of such conversion in the acquisition of property of a character similar or related in service or use to the property so converted or in the establishment of a replacement fund. Under such circumstances, while the entire profit resulting from the conversion is to be reported in gross income, there is allowed as a deduction from gross income an amount equal to that proportion of the gain derived which the portion of the proceeds so expended bears to the entire proceeds.

Section 229 makes provision for the treatment as a corporation from January 1, 1921, of a business then conducted by an individual or a partnership where a corporation is organized within four months after November 23, 1921, to take over the business of such individual or partnership.

3. CHANGES TO PREVENT THE EVASION OF TAXATION.

Where corporations are availed of for the purpose of accumulating profits and thus preventing the imposition of the surtax upon its stockholders, a penalty in the form of a tax equal to 25% of the net income is imposed, in addition to other taxes payable. If, however, the stockholders of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes that would otherwise be imposed upon the corporation for the taxable year, tax the stockholders of such corporation upon their shares in the net income of the corporation for the taxable year in the same manner as in the case of the members of a partnership.

Another provision of the law takes out of the hands of the taxpayers the possibility of selling stock or securities in order to register losses for tax purposes and immediately buying other or like securities, which action therefore results only in "paper" losses. Under section 214 no deduction for loss is allowed if sustained after November 23, 1921, if within a period of 30 days before or after the date of the sale of the stock or securities the taxpayer acquires substantially identical property and holds the same for any period after the date of acquisition. In other words, "wash sales" will no longer be recognized.

A common method of avoiding taxes prior to the enactment of the Revenue Act of 1921 was by means of gifts. Thus where, for example, an individual held property which had considerably appreciated in value over and above the cost or March 1, 1913, value (depending upon the base to be used in the computation of profit upon sale) a common practice has been to give to a near relative such property as an absolute and irrevocable gift. The donor would realize no profit while the donee would realize very little if any profit upon the sale of the property as the taxable profit would be measured by the difference between the value of the property at the date of acquisition by the donee and the sale price. The Revenue Act of 1921, however, provides that in the case of a gift made after December 31, 1920, and the subsequent sale by the donee

of the property thus received by way of a gift, the profit or loss arising from such sale would be the difference between the sale price and the basic value (for the purpose of computing a profit in the event of a sale) to the donor as if no such gift had been made.

The Revenue Act of 1921 provides that a stock dividend is not subject to tax. If, however, stock is so distributed and is later cancelled or redeemed by the corporation so that the stock dividend in effect becomes a taxable dividend, then the amount received for the stock is treated as a taxable dividend to the extent of earnings or profits accumulated by the corporation after February 28, 1913.

4. MISCELLANEOUS CHANGES.

Under the Revenue Act of 1918 personal-service corporations are not taxable as ordinary corporations. The stockholders of such personal-service corporations are, in this Act, taxable in the same way as partners of a partnership, that is, each stockholder is taxed on the profits accruing to him individually. Under the Revenue Act of 1921, however, the taxation of personal-service corporations in the manner just stated ceases after December 31, 1921, and personal-service corporations are taxed 12½% on their net income just as other corporations.

A corporation with a net income of over $25,000 is no longer allowed a specific credit while a corporation whose net income is less than $25,000 is allowed a specific credit of $2,000 in the computation of the income tax. However, if the net income is in excess of $25,000 the tax cannot be greater than the sum of the excess of the net income over $25,000 and a tax computed with an allowance of a specific credit of $2,000.

Individuals are required to file returns if their gross income is $5,000 or more, even though the net income is less than the individual's specific exemption.

Consolidated returns are still required in the case of affiliated corporations for the taxable year 1921 or for any taxable period beginning in 1921 and ending in 1922. However, for any taxable year beginning after December 31, 1921, affili-

ated corporations have the option of filing either separate returns or consolidated returns. When such option has been exercised, however, the method elected is required to be followed thereafter unless permission to change is granted by the Commissioner.

A provision of particular interest and perhaps of far-reaching importance is that contained in section 240 wherein the Commissioner is authorized to consolidate the accounts of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests. Such consolidation, however, is not for the purpose of filing a consolidated return but is for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

Under section 250 the time within which taxes due for 1921 and subsequent years under the Revenue Act of 1921 may be assessed is limited to four years from the time of filing the return. Taxes due, however, for any year prior to 1921 on account of returns filed under the Revenue Act of 1921 or under prior Acts may be assessed at any time within five years of the date of filing the return. However, these limitations do not apply in the case of fraudulent returns. Where such returns have been filed the tax may be assessed at any time.

Section 250 also provides that the taxpayer shall be duly notified of any deficiency in tax discovered upon examination of the return and shall be given a period of not less than 30 days within which to file an appeal and show cause or reason why the tax deficiency should not be paid. After the taxpayer has thus had full opportunity to be heard the tax found to be due by the Commissioner, taking into consideration all information on hand, is assessed and must be paid. Seemingly where full opportunity has thus been given the taxpayer to show cause or reason why the tax should not be assessed and he has

failed to do so, he cannot avail himself of the privilege (as heretofore) of filing a claim for abatement.

The Revenue Act of 1921 continues a provision with respect to the allowance of a credit against United States income taxes because of foreign income or profits taxes paid by the taxpayer. The amount of such foreign income and profits taxes, however, is allowable as a credit only to the extent that it does not exceed that proportion of the tax against which credit is claimed which the income from foreign sources bears to the entire net income for the same taxable year.

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FEDERAL INCOME TAX PROBLEMS

PROBLEM 1

Illustrating Personal Service Corporations

FACTS:

The Architectural Service Co. Inc., organized under the laws of the State of Illinois, is composed of five architects each of whom is actively engaged in the business. It has a paid-in capital of $500.00. The company specializes in planning industrial buildings and its sole income for the taxable year 1921 was as follows:

Commissions and consultation fees	$75,581.96
Interest on current bank balances	372.49
Total	$75,954.45

There is a small office force, but the earnings are due primarily to the activities of the five stockholders. The company has never been involved in a government contract, nor has it ever traded as a principal.

QUESTION (A):

Is the Architectural Service Co. Inc., a "personal-service corporation," and if so, how is it to be taxed for the year 1921?

ANSWER:

It is a personal-service corporation because its earnings are due primarily to the activities of its stockholders, and not to its capital invested, nor is its income derived from Government contracts made between April 6, 1917, and November 11, 1918, nor does the company engage in trading. For the taxable year

1921 it is not subject to income and profits taxes, but its earnings for the year are taxable in the hands of the stockholders (whether distributed or not) as if it were a partnership.

REFERENCES:

Sec. 200 (5): "The term 'personal service corporation' means a corporation whose income is to be ascribed primarily to the activities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive."

Sec. 218 (d): "Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title[1] relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided*, That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares. . . ."

Sec. 231: "That the following organizations shall be exempt from taxation under this title[1]—. . . . (14) Personal service corporations. This subdivision shall not be in effect after December 31, 1921."

QUESTION (B):

Assuming the same facts as above, except that the taxable year was 1922, how should the company be taxed?

ANSWER:

In 1922 personal-service corporations are subject to the same taxes and rates as other taxable corporations. The rate in 1922 is 12½% of the net income in excess of the credits allowed under section 236.

REFERENCE:

See Problem 171 for illustration of taxation at 1922 rates.

[1] Refers to Title II, covering income tax.

PROBLEM 2

Illustrating Taxability as Personal Service Corporation—Foreign Corporation

FACTS:

The Swedish Match Export Co., organized under the laws of Sweden, and licensed to do business in the State of New York, is selling agent in America for a certain brand of safety matches. There are five stockholders, two of whom are in charge of the Stockholm office, and three are active in the New York office. The company merely acts as intermediary between manufacturer and purchaser and assumes no obligations to either. Its sole income is derived from the commissions earned in placing the orders, and collecting the agreed sales price. The facts above stated apply for the calendar year 1921. The Swedish Match Export Co. files its returns on the calendar-year basis.

QUESTION:

Is the Swedish Match Export Co. to be taxed as a "personal service corporation" for the calendar year 1921?

ANSWER:

No; even though its earnings were solely the result of the activities of the stockholders, and capital was not an income-producing factor, and the company did not derive its income from trading as a principal, it would not be taxed as a personal-service corporation because it is a foreign corporation.

REFERENCE:

Sec. 200 (5). (Quoted under Problem 1.) See Problem 1.

PROBLEM 3

Illustrating Taxability of Dividends Distributed By a Personal Service Corporation Out of Earnings Accumulated Prior to March 1, 1913; Subsequent to Feb. 28, 1913, but Prior to January 1, 1918; Subsequent to December 31, 1917, but prior to January 1, 1922; Subsequent to December 31, 1921

FACTS:

The Andrews Audit Company, a personal-service corporation, on February 1, 1922 distributes as a dividend its entire surplus which was accumulated as follows:

January 1, 1910, to Feb. 28, 1913	$ 50,000
March 1, 1913, to Dec. 31, 1917	130,000
January 1, 1918, to Dec. 31, 1921	270,000
January, 1922	5,000

QUESTION:

What portion of this dividend is taxable?

ANSWER:

The $130,000 and the $5,000 are taxable. The $50,000 accumulated prior to March 1, 1913 and the $270,000 representing the accumulation of earnings of a personal-service corporation in the period from Jan. 1, 1918, to Dec. 31, 1921, inclusive, are upon distribution exempt from tax.

REFERENCE:

Sec. 201 (a): "The term 'dividend' when used in this title[1] . . . means any distribution . . . except a distribution made by a personal service corporation out of earnings or profits accumulated since December 31, 1917, and prior to January 1, 1922. (b) For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed."

[1] Refers to Title II, covering income tax.

PROBLEM 4

Illustrating Taxability of Dividends Paid in Liberty Bonds

FACTS:

The Bellwood Corporation declared a dividend of $150,000 payable in Liberty Bonds having a par value of that amount. The market value of the bonds on the date the dividend was payable was $140,000. On the same date the company had a surplus of $300,000, all earned since 1913.

QUESTION:

At what amount must the stockholders report the dividends as income?

ANSWER:

Dividends subject to tax, received in the form of property of any kind, should be taken into income at the fair market value of such property as of the date receivable.

REFERENCE:

Art. 1547, Regulations 62: "Dividends paid in securities or other property (other than its own stock) in which the earnings of a corporation have been invested, are income to the recipients to the amount of the market value of such property when receivable by the stockholders. . . ."

PROBLEM 5

Illustrating Taxability of Cash Dividends Declared Payable Out of Depletion Reserve

FACTS:

The Evans Engineering Corporation on December 15, 1921, declared a cash dividend of $188,000 payable Dec. 31, 1921, $160,000 to be paid out of the company's depletion reserve.

The balance sheet of the company on December 31, 1921, appeared as follows:

ASSETS		LIABILITIES	
Cash	$ 30,000	Accounts Payable ..	$ 40,000
Accounts Receivable	20,000	Mortgage	100,000
Liberty Bonds (cost and par value) ...	150,000	Reserve for Depletion of Mine	160,000
Plant and Equipment (cost less depreciation)	300,000	Capital Stock	500,000
Mine (March 1, 1913, value)	500,000	Surplus	200,000
	$1,000,000		$1,000,000

The mine was acquired in 1910 for $350,000, but was not operated until 1914. The depletion reserve of $160,000 had accumulated by a credit of 4% of the March 1, 1913, value for each year from 1914 to 1921, inclusive, the number of tons of mineral removed each year continuing unchanged.

An analysis of the surplus account showed the following:

March 1, 1913	Deficit	$ 60,000
Dec. 31, 1913	Loss since March 1, 1913	30,000
		$ 90,000
Dec. 31, 1913	Mine appreciated to Mar. 1, 1913 value	150,000
		$ 60,000
Year 1914	Earnings after providing for depletion and depreciation..	40,000
Year 1915	" " "	50,000
Year 1916	" " "	70,000
Year 1917	" " "	140,000
Year 1918	" " "	320,000
		$680,000

Dec. 31, 1918	Cash dividend paid		400,000
			$280,000
1919	Loss after providing for depletion and depreciation..	$ 10,000	
1920	" " "	40,000	
1921	" " "	30,000	80,000
	Surplus December 31, 1921		$200,000

QUESTION:

How much of the dividend is taxable to the recipients?

ANSWER:

Surplus December 31, 1921, as per books...	$200,000
Deficit March 1, 1913	60,000
Realized appreciation in the Depletion Reserve (4% of $150,000 × 8 years)	48,000
Total	$308,000
Less: Appreciation of mine	150,000
Earnings since March 1, 1913	$158,000

Since the stockholders received $188,000, and the amount of surplus available for distribution was $158,000, the balance, $30,000, was paid out of the depletion reserve (based on cost), and was therefore a return of capital to the stockholders. The $158,000 is taxable to the recipients as ordinary dividends.

REFERENCES:

Sec. 201 (a): "That the term 'dividend' when used in this title (except in paragraph (10) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders or members, whether in cash or in other property, out of its earnings or profits accumulated since February 28, 1913. . . ."

(b) "For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated

earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed."

(c) "Any distribution (whether in cash or other property) made by a corporation to its shareholders or members otherwise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee."

PROBLEM 6

Illustrating Taxable Profit on Sale of Stock Where Stock Dividend Involved

FACTS:

The Chiswell Manufacturing Company was organized January 1, 1910, at which time its $10,000 par value common stock was issued for cash at $110 per share. Through subsequent reverses the $1,000 paid-in surplus was entirely lost, and on February 28, 1913, the balance sheet of the company showed a deficit of $2,000. To eliminate this deficit each stockholder was assessed $20 per share on March 1, 1913, so that the market value and book value of the stock at this date were each equal to par. After this date the company operated at a profit.

Mr. York who was an original subscriber for 10 shares of the stock and continued his holdings until after receiving a stock dividend (the only dividend paid by the company) of 10 additional shares of common stock sold the original 10 shares in 1921 for $1,500.

QUESTION:

What part, if any, of this $1,500 is taxable to Mr. York, and at what rates?

ANSWER:

Mr. York had 20 shares (10 original plus 10 stock dividend)

which cost him $1,300, or $65 per share. His taxable profit was therefore $85 per share, or $850. This profit is taxable at both normal-tax and surtax rates.

REFERENCE:

Article 1548 (1), Reg. 62: ". . . . Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share (or when acquired prior to March 1, 1913, the fair market value as of such date) will be the quotient of the cost (or such fair market value) of the old shares of stock, divided by the total number of the old and new shares. . . ."

PROBLEM 7

Illustrating Taxable Net Income on Sale of Dividend Stock

FACTS:

In 1914, Mr. Julian Atkins purchased 50 shares of W. H. Dare Co. stock at 108. In 1916, he purchased 30 additional shares at 180.

In 1917, he received a stock dividend of 80%.

In 1921, he sold the 30 shares, purchased in 1916, and 20 shares of dividend stock, which could not be definitely allocated as between the first two lots purchased, all at $90 per share.

QUESTION:

What is Mr. Atkins' taxable net income on the sale of this stock?

ANSWER:

The 30 shares, purchased in 1916, cost $5,400. On these he received 24 shares of dividend stock, making a total of 54 shares for $5,400 and an average cost of $100 per share. He consequently lost $10 per share on these, or $300.

The 50 shares purchased in 1914 cost $5,400. On these he received 40 shares of dividend stock, making a total of 90 shares for $5,400 and an average cost of $60 per share. His profit on the dividend stock was, therefore, $30 per share, or $600.

The profit of $600 and the loss of $300 makes a net profit of $300 on the sale.

REFERENCE:

Article 1548 (4), Reg. 62: "Where the stock with respect to which a stock dividend is declared was purchased at different times and at different prices, and the dividend stock issued with respect to such stock can not be identified as having been issued with respect to any particular lot of such stock, then any sale of such dividend stock will be presumed to have been made from the stock issued with respect to the earliest purchased stock, to the amount of the stock dividend chargeable to such stock."

PROBLEM 8

Illustrating Taxability of Cash Dividend Paid out of Earnings Accumulated in Part Prior to March 1, 1913, And in Part on or Subsequent to That Date

FACTS:

The balance sheet of the Brookland Bolt Co., Meadowbrook, Md., on December 31, 1921, the end of the company's accounting year, appeared as follows:

ASSETS		LIABILITIES	
Cash	$55,000	Accounts Payable	$10,000
Accounts Receivable	20,000	Capital Stock	50,000
Inventories	20,000	Surplus	90,000
Plant	55,000		
	$150,000		$150,000

The surplus was accumulated as follows:

Surplus on March 1, 1913	$120,000
Loss March 1, 1913 to December 31, 1915	40,000
	$ 80,000
Earnings January 1, 1916 to December 31, 1921	10,000
	$ 90,000

A cash dividend of $50,000 was declared payable January 3, 1922.

QUESTION:

Is any of this dividend taxable? If so, how much?

ANSWER:

$10,000, or 20%, of the dividend is taxable, this being the amount accumulated after February 28, 1913.

The loss in 1913, 1914, and 1915 served to reduce the surplus accumulated prior to that time, not to offset future earnings.

REFERENCES:

Sec. 201 (b): "For the purpose of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; . . ."

Bul. 31-20-1098; O. D. 610: ". . . The operating losses of the company . . . are not to be charged against the earnings or profits of any particular year, and the fact that there were such losses does not prevent or alter the application of the rule that the dividend will be deemed to have been paid from earnings accumulated since February 28, 1913. . . ."

Bul. 40-20-1219: A. R. M. 82 (superseding O. D. 610, part of which is quoted above): "The word 'accumulated' as used in this sense means, in the judgment of the Committee, profits which have been earned and not dissipated by *subsequent* losses."

PROBLEM 9

Illustrating Computation of Loss on Sale of Stock or Shares on Which Dividend has been Received From Earnings Accumulated Prior to March 1, 1913

FACTS:

Amos Aaron in April, 1913, purchased 10 shares of stock in the Brookland Bolt Company, Meadowbrook, Maryland, at $210 per share. On January 3, 1922 he received a dividend of $100 per share, $80 per share of which was paid from earnings accumulated prior to March 1, 1913. In February, 1922, Mr. Aaron sells his stock at $120 per share.

QUESTION:

What, if any, is Mr. Aaron's loss per share?

ANSWER:

The tax-free distribution of $80 per share from earnings accumulated prior to March 1, 1913, would in effect reduce the cost of Mr. Aaron's stock to $130 per share. The sale of the stock at $120 per share results in a loss to Mr. Aaron of $10 per share.

REFERENCE:

Sec. 201 (b): "For the purposes of this Act every distribution is made out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon."

See Problem 8.

PROBLEM 10

Illustrating Computation of Profit or Loss on Sale of Capital Stock on Which Liquidating Dividend Has Been Paid

FACTS:

T. F. Evans in 1910 acquires 200 shares of stock in the Evans Engineering Corporation at $92 per share. In 1921 he received a cash dividend of $37.60 per share, $6 per share of which constituted a return of capital. There were no other liquidating dividends and no stock dividends. The March 1, 1913, value of the stock was $90 per share. Mr. Evans sells his stock in 1922 at $85 per share.

QUESTION:

What was the taxable profit or the deductible loss per share?

ANSWER:

The distribution of $6 per share served to reduce the cost from $92 per share, to $86 per share, and the March 1, 1913, value from $90 per share to $84 per share. There was, therefore, no taxable profit and no deductible loss, the stock having been sold for $85, a price below cost base ($86), but above March 1, 1913, value base ($84).

REFERENCE:

Sec. 201 (c): (Quoted under Problem 5.)

PROBLEM 11

Illustrating Effect of Stock Dividend with Subsequent Redemption or Cancellation of Stock so Distributed

FACTS:

The Anderson Brooks Corporation planned to make a distribution of dividends in such a manner as to save its stockholders from taxation on the amounts received by them. To effect this evasion of tax the corporation declared a stock dividend payable September 15, 1921, in an amount less than the earnings accumulated since February 28, 1913, and a few days later redeemed the stock so distributed.

QUESTION:

Is this stock dividend subject to taxation in the hands of the stockholders?

ANSWER:

Yes.

REFERENCE:

Sec. 201 (d): "A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such

manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913."

PROBLEM 12

Illustrating Taxability of Dividends Received in One Year, Distributed From Earnings Accumulated in Prior Years

FACTS:

The Freeport Furniture Company, which keeps its books on a calendar-year basis, distributes a dividend on January 15, 1921. This being within the first sixty days of the distributing company's accounting year, and the distribution having taken place before January 1, 1922, the distribution must be deemed (according to Sec. 201-f) to have been made from earnings or profits accumulated during preceding taxable years. It is therefore found that the distribution was made from earnings accumulated in 1916.

QUESTION:

The distribution having been made in 1921, from earnings accumulated in 1916, when the tax rates were much lower, at what year's rates are the dividends taxable to the recipient stockholder?

ANSWER:

The dividend is taxable at 1921 rates.

REFERENCES:

Sec. 201 (e). (Quoted under Problem 13.)

Sec. 201 (f). "Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable year shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits,

the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921."

Bul. 1-19-9; O. D. 5: "The 60-day provision of section 201 (e) of the Revenue Act of 1918 is not for the purpose of determining the rates of tax to be paid by the shareholders, but is for the purpose of allowing the corporation to determine the earnings from which the dividend is paid."

PROBLEM 13

Illustrating Taxability of Dividends Paid in One Calendar Year and Received by Stockholders in Succeeding Year

FACTS:

The Atlas Book Concern on December 27, 1921, declared a cash dividend payable December 31, 1921. Dividend checks were accordingly mailed December 31, 1921, but out-of-town stockholders did not receive their checks until early in 1922.

QUESTION:

For what year do the out-of-town stockholders, reporting on the calendar-year basis, report as income the dividends mailed to them in 1921 but received by them in 1922?

ANSWER:

The dividends should be reported as income in 1921.

REFERENCES:

Sec. 201 (e): "For the purposes of this Act, a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands."

Bul. 2-19-140; O. D. 97: "The date of payment rather than the date of receipt is the governing factor in determining when a dividend should be treated as taxable income to the recipient. Consequently, a dividend paid in Kansas, and received there by stockholders December 30, 1917, but not received by stockholders in California until January, 1918, will be taxable at 1917 rates to the California stockholders."

PROBLEM 14

Illustrating Method of Determining Gain or Loss From the Sale of Property Acquired After March 1, 1913

FACTS:

The Conklin Bakery, Inc., purchased an auto truck for $2,500 January 2, 1918. On July 1, 1921, the auto truck was sold for $500. It was found from experience that the average life of auto trucks used by this concern was four years.

QUESTION:

Did the above corporation sustain a loss or derive a profit from the sale of the truck?

ANSWER:

The basis for computing the gain or loss from the sale is the cost less the depreciation to date of sale. Since the truck had an expected life of four years the annual rate of depreciation would be 25%. The taxable income to the corporation from the sale is found by the following computation:

Selling price July 1, 1921		$500.00
Cost January 2, 1918	$2,500.00	
Minus depreciation Jan. 1, 1918, to July 1, 1921, (three and one-half years) at 25% per annum	2,187.50	
Depreciated value		312.50
Profit on sale		$187.50

REFERENCES:

Sec. 202 (a): "The basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property real, personal, or mixed acquired after February 28, 1913, shall be the cost of such property: . . . "

Art. 1561, Reg. 62: "For the purpose of ascertaining the gain or loss from the sale or exchange of property . . . proper adjustment must be made . . . for any depreciation or depletion sustained."

PROBLEM 15

Illustrating Basis For Determining Gain or Loss From The Sale of Property Which Should be Included in Inventory

FACTS:

Harris A. Miller, a retail clothier, had a supply of raincoats which he had carried in stock for three years. The raincoats had cost him $17 each. He attempted to sell them in December, 1920, for $15 each. In closing his accounts for the calendar year 1920, which was the basis for the filing of his income tax returns, such raincoats (100) as remained unsold on December 31, 1920, were priced at $15 per coat. Mr. Miller had followed the practice of inventorying on the basis of cost or market, whichever was lower. In October, 1921, Mr. Miller disposed of all his coats at $10 each.

QUESTION:

What is the deductible loss (for tax purposes) as a result of this sale?

ANSWER:

The deductible loss is computed as follows:

100 raincoats inventoried December 31, 1920, at	$15 per coat	$1500
100 raincoats sold October, 1921, for	10 " "	1000
Deductible loss on sale		$ 500

REFERENCE:

Sec. 202 (a): "That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that . . . (1) In the case of such property, which should be included in the inventory, the basis shall be the last inventory value thereof; . . ."

PROBLEM 16

Illustrating Basis of Computing Gain Derived or Loss Sustained from the Sale of Property Acquired by Gift On or Prior to December 31, 1920

FACTS:

James S. Morton purchased 100 shares of stock of the Interstate Oil Company August 4, 1911, for $25 per share. The March 1, 1913, value of this stock was $50 per share. Mr. Morton donated the above shares to Howard Lewis December 25, 1920, upon which date the market value of these shares was $60 per share. On October 16, 1921, Mr. Lewis sold the above 100 shares of the Interstate Oil Company stock for $75 per share.

QUESTION:

Upon what basis should the taxable profit derived by Mr. Lewis from the sale of the above stock be computed?

ANSWER:

As Mr. Lewis acquired the stock by gift prior to December 31, 1920, the gain from the sale of the stock would be computed by deducting from the selling price the value of the shares at the time acquired from the donor.

Selling price—Oct. 16, 1921	
100 shares @ $75 per share	$7,500
Value—December 25, 1920, (date acquired from donor)	
100 shares @ $60 per share	6,000
Taxable profit	$1,500

REFERENCE:

Sec. 202 (a): "That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that . . . (2) . . . In the case of such property acquired by gift on or before December 31 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of sucn property at the time of such acquisition; . . ."

PROBLEM 17

Illustrating Basis for Computing Gain Derived or Loss Sustained from Sale of Property Acquired by Gift after December 31, 1920

FACTS:

Mr. Robert Brown, Jr., acquired fifty shares of United States Steel Company common stock by gift from his father January 7, 1921, which shares were acquired by the latter in 1916 at $125 per share. U. S. Steel common was selling for $82.75 per share January 7, 1921. In July, 1921, Mr. Robert Brown, Jr., sold the above stock at $78 per share.

QUESTION:

What is the basis for computing the gain derived or the loss sustained? What, if any, was the amount of the loss?

ANSWER:

The basis for computing the gain derived or the loss sustained is the cost to the donor (having been acquired by him after March 1, 1913), as the stock was acquired by gift after December 31, 1920. Since the stock was acquired at $125 per share by the donor and sold by the donee at $78 per share, the donee sustained a loss equal to the difference, or $47 per share.

REFERENCE:

Sec. 202 (a) (2): "In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. . . ."

PROBLEM 18

Illustrating Basis for Determining the Gain Derived or Loss Sustained from the Sale of Property Received by Inheritance after February 28, 1913

FACTS:

Mr. Herman Hodges was the son and sole heir of Mr. William

J. Hodges. On April 10, 1918, Mr. William J. Hodges died intestate. Among the assets in the decedent's estate was an office building which cost $15,000, but which on April 10, 1916, was valued at $20,000. The expected life of the building from April, 1916, was estimated to be 20 years. Mr. Herman Hodges, having inherited the entire estate of his father, held the building until April 10, 1921, when it was sold for $18,000.

QUESTION:

What is the taxable gain or deductible loss to Mr. Herman Hodges as the result of the sale above mentioned?

ANSWER:

Mr. Hodges derived a taxable profit from the above sale represented by the difference between the selling price and the fair market value of the building on the date it was acquired by him by way of inheritance (after making proper provision for depreciation during the entire period the building was held by him, up to the date of sale).

Selling price April 10, 1921		$18,000
Value on April 10, 1916	$20,000	
Depreciation from April 10, 1916 to April 10, 1921 (5 years at the rate of 5% per annum)	5,000	15,000
Taxable profit		$ 3,000

REFERENCES:

Sec. 202 (a): "That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that . . . (3) in the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402."

Section 402 has reference to the Estate Tax.

Art. 1561, Regulations 62: ". . . Proper adjustment must be made . . . . for any depreciation or depletion sustained. . . . ."

PROBLEM 19

Illustrating Method of Determining Gain Derived From Sale of Property Acquired by Bequest Prior to March 1, 1913 in Case the Fair Market Value as at March 1, 1913 was in Excess of Value at Date of Acquisition, but Less than the Selling Price

FACTS:

Charles Dorset purchased an apartment house (together with the land on which it stood) in 1910 for $100,000. He died August 13, 1912, and by the terms of his will bequeathed this property to his son, Frank Dorset. The fair market value of the building on August 13, 1912, was estimated to be $125,000, and the fair market value of the land on this date was estimated to be $25,000. The fair market value of the entire property on March 1, 1913 was estimated to be $210,000. Frank Dorset continued to hold title to this property until August 15, 1921, when he sold it for $250,000 in cash. Engineers estimated that the depreciation on the apartment house was 2% per annum based upon its expected life from March 1, 1913. The value of the land on March 1, 1913, was estimated to be the same as it was on August 13, 1912.

QUESTION:

What is the profit derived by Frank Dorset as the result of the sale above mentioned?

ANSWER:

As the fair market value of the property on March 1, 1913, is in excess of its value at the date acquired by Frank Dorset, the taxable profit is the difference between the proceeds from the sale of said property ($250,000) and the depreciated March 1, 1913, value of said property ($178,704). This latter figure as well as the taxable profit is arrived at as follows:

Value of entire property March 1, 1913	$210,000
Value of land " " "	25,000
" " apartment house " " "	$185,000

Depreciation on apartment house for 8 years $5\frac{1}{2}$ months (March 1, 1913, to August 15, 1921), at rate of 2% per annum	31,296
Depreciated March 1, 1913, value of apartment house	$153,704
March 1, 1913, value of land	25,000
Base in computing profit	$178,704
Sale price of property	250,000
Taxable profit	$ 71,296

REFERENCE:

Sec. 202 (b): "The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—(1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value; . . ."

For quotation of section 202 (a) see Problems 15, 16, 17 and 18.

PROBLEM 20

Illustrating Basis of Computing Amount of Loss Sustained from Sale of Property Received as a Bequest in Case Selling Price is Less than Value at Date of Acquisition, Which Latter Value is Less than Fair Market Value March 1, 1913

FACTS:

Under the terms of the will of Robert Clark, 500 shares of P. D. Q. RR. Co. stock were bequeathed to his brother Jerome Clark. Robert Clark died August 6, 1912. The fair market value of the above-mentioned stock on August 6, 1912, was $50,000. The fair market value of the property at March 1, 1913, was $75,000. Subsequently the railroad ceased paying the large dividends it had paid in former years, so Mr. Clark sold the 500 shares August 10, 1921, for $25,000.

QUESTION:

What was the amount of the deductible loss if any, sustained by Mr. Clark on the sale of the 500 shares of stock?

ANSWER:

The basis for computing the amount of loss sustained is the fair market value at time of inheritance.

Fair market value of the 500 shares of stock on August 6, 1912	$50,000.00
Selling price of 500 shares on Aug. 10, 1921	25,000.00
Deductible loss on sale of the stock	$25,000.00

Where the fair market value at March 1, 1913, of a bequest received prior to that date is greater than the value at the date of its acquisition and the selling price is less than the value at acquisition, the deductible loss is the amount by which the value at acquisition by bequest exceeds the selling price.

REFERENCES:

Art. 1563, Reg. 62: ". . . In the case of property acquired by gift, bequest, devise, or inheritance, prior to March 1, 1913, the taxable gain or deductible loss from the sale or other disposition thereof shall be computed in accordance with article 1561. . . ."

Art. 1561, Reg. 62: ". . . Where the fair market value as at March 1, 1913, is greater than the cost and the selling price is less than the cost, the deductible loss is the amount by which the cost exceeds the selling price. . . ."

PROBLEM 21

Illustrating Method of Determining Amount of Taxable Profit Derived or Loss Sustained from the Sale of Property Received as a Bequest Prior to March 1, 1913 in Case the Market Value at Date of Acquisition is Less than Selling Price but March 1, 1913, Value is Greater than Selling Price

FACTS:

Mrs. Margaret Smith died on August 19, 1909, and under the

terms of her last will and testament she bequeathed to her daughter, Mary Smith, five shares of the capital stock of the Highbridge Coal Company. The market value of this stock in August, 1909, was $60 per share; on March 1, 1913, the market value of the stock was $85 per share. Mary Smith sold the five shares on June 16, 1921, for $75 per share.

QUESTION:

Did Mary Smith sustain a deductible loss or derive a taxable gain from the sale of the stock?

ANSWER:

The sale results in neither gain nor loss from a tax standpoint.

REFERENCE:

Sec. 202 (b): "The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but . . . (3) If the amount realized therefor is more than such basis but not more than its fair market price or value as of March 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income. . . ."

For quotation of section 202 (a) see Problems 15, 16, 17 and 18.

PROBLEM 22

Illustrating Method of Determining Amount of Taxable Profit Derived or Loss Sustained from the Sale of Property Received as a Bequest Before March 1, 1913, in Case the Market Value at March 1, 1913, is Less than Selling Price, but Market Value at Date of Acquisition is Greater than Selling Price

FACTS:

By the will of Andrew Black, who died April 6, 1905, a section of land on the west shore of Lake Champlain was devised to his son William Black. The value of the land in April, 1905, was $25,000. A forest fire in 1912 destroyed the trees on the

adjoining properties, greatly marring the scenic beauty of the countryside. The value of the property on March 1, 1913, was appraised at $10,000. In October, 1921, Mr. Black sold the above property for $15,000.

QUESTION:

Did Mr. Black sustain a deductible loss or did he derive a taxable gain?

ANSWER:

While the proceeds from the sale of the property were in excess of the March 1, 1913, value thereof, such proceeds were less than the value at the time acquired by William Black and therefore the sale reflects neither a taxable gain nor a deductible loss.

REFERENCES:

Sec. 202 (a) (3). (Quoted under Problem 18.)
Sec. 202 (b) (3). (Quoted under Problem 21.)

PROBLEM 23

Illustrating Basis for Determining Amount of Taxable Profit Derived from Sale of Property Purchased Prior to March 1, 1913, in Case the Cost is Greater than March 1, 1913, Value and Less than Selling Price

FACTS:

Mrs. Mary A. Johnson purchased 10,000 shares of the capital stock of the Hugo Manufacturing Co. June 16, 1911, paying therefor $90 per share. On March 1, 1913, the market value of the stock was $55 per share. On July 1, 1921, Mrs. Johnson sold these shares receiving therefor $100 per share.

QUESTION:

What taxable profit did Mrs. Johnson derive from the sale of this stock?

ANSWER:

When the cost is equal to or greater than the fair market value as at March 1, 1913, and the selling price exceeds the cost, the taxable profit is the excess of the selling price over the cost. This profit is therefore computed as follows:

Amount received at date of sale, 10,000 shares at $100.00 per share	$1,000,000
Less: Cost 10,000 shares at $90.00 per share	900,000
Taxable profit	$ 100,000

REFERENCES:

Sec. 202 (b) (1). (Quoted under Problem 19.)

Sec. 202 (a). (Quoted under Problem 14.)

Art. 1561, Regulations 62: ". . . Where the cost is equal to or greater than the fair market value as at March 1, 1913, and the selling price exceeds the cost, the gain to be included in gross income is the excess of the selling price over the cost. . . ."

PROBLEM 24

Illustrating Method of Determining Gain from Sale of Property Acquired by Purchase Prior to March 1, 1913, in Case the Fair Market Value of the Property on March 1, 1913, is Greater than Cost but Lower than Selling Price

FACTS:

William Hewitt, on May 1, 1900, purchased a certain lot for $10,000. The appraised value of this lot on March 1, 1913, was $15,000. On July 6, 1921, Mr. Hewitt sold this lot for $25,000.

QUESTION:

How much taxable profit did Mr. Hewitt derive from the sale?

ANSWER:

As the lot in question was acquired prior to March 1, 1913,

and its value on that date was in excess of cost, such value is under the law used as the basis for determining the profit which is computed as follows:

Selling price July 6, 1921	$25,000
Fair market value, March 1, 1913	15,000
Net profit subject to tax	$10,000

REFERENCE:

Sec. 202 (b): "The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but (1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value; . . ."

For quotation of section 202 (a) see Problems 15, 16, 17 and 18.

PROBLEM 25

Illustrating the Basis for Determining Gain or Loss When Property is Exchanged for Property not Having a Readily Realizable Market Value

FACTS:

Mr. William Howe purchased 160 acres of farm land located near Springfield, Mass., for $4,000 on May 1, 1918. He exchanged the above farm land October 1, 1921, for one thousand acres of uncleared land located in Northern Minnesota. Uncleared land in the same locality in Minnesota as the above had been sold two years previous for $5 per acre, but there were no subsequent sales of such property, although real estate dealers carried large blocks of this kind of property on their books for sale.

QUESTION:

Did Mr. Howe derive a taxable profit or sustain a deductible loss from the above transaction?

ANSWER:

Mr. Howe's taxable status remains the same as if the above exchange had not taken place, since the uncleared land did not have a readily realizable market value at the date of exchange. No gain or loss is recognized unless the property received in exchange has a readily realizable market value.

REFERENCE:

Sec. 202 (c) : "For the purposes of this title,[1] on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value. . . ."

[1] Refers to Title II, covering income tax.

PROBLEM 26

Illustrating the Basis for Determining Gain or Loss When Property Is Exchanged for Property of a Like Kind or Use

FACTS:

On August 6, 1918, the Wagner Furniture Company, a wholesale furniture house located in New York City, paid $15,000 for a storage warehouse in Jersey City. The furniture stored in this warehouse was used to supply the demands of New Jersey customers. In the early part of 1921, the New Jersey Glass Company desired to extend its factory which was located on the lot adjacent to the above-mentioned warehouse so as to take in the warehouse and offered either to pay $20,000 cash or to exchange one of its warehouses in Hoboken, N. J. for the Jersey City warehouse. The Wagner Furniture Company decided to accept the second offer. Deeds to the properties in question were exchanged May 9, 1921.

QUESTION:

Did the Wagner Furniture Company derive a taxable profit from the above transaction?

ANSWER:

No taxable profit resulted from the above transaction even

though the property received in exchange had a readily realizable market value, because property was exchanged for property of a like kind or use.

REFERENCE:

Sec. 202 (c) : "For the purposes of this title,[1] on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

"(1) When any such property held for investment, or for productive use in trade or business (not including stock-in-trade or other property held primarily for sale), is exchanged for property of a like kind or use; . . ."

PROBLEM 27

Illustrating Basis for Determining Gain or Loss, When in a Reorganization Stock of One Corporation is Exchanged for Stock of Another Corporation a Party to the Reorganization

FACTS:

The Corby Steel Company was consolidated June 10, 1921, with the Northwestern Steel Company. Mr. Hiram H. Corby was the owner of eight thousand shares, or 80 per cent of the total outstanding capital stock (all of one class) of the Corby Steel Company stock on June 10, 1921. He had acquired this stock for $50 per share on April 1, 1912. As the result of the consolidation of the two companies above mentioned, Mr. Corby received in exchange for his eight thousand shares of Corby Steel Company stock an equal number of shares of Northwestern Steel Company stock. This exchange took place June 10, 1921, on which date the stock of the Northwestern Steel Company received by Mr. Corby had a market value of $110 per share.

QUESTION:

Did Mr. Corby derive a taxable profit from the above transaction? If so, how much?

ANSWER:

Mr. Corby derived no taxable profit whatsoever from the above exchange of stock as no gain or loss is recognized for tax purposes when in the reorganization of one or more corporations a person receives in place of stock owned by him, stock in a corporation a party to such reorganization.

REFERENCE:

Sec. 202 (c): "For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized . . . . (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word 'reorganization' as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); . . ."

PROBLEM 28

Illustrating Result of Exchanging Property for Stock in a Corporation whose Stock is closely Held

FACTS:

Mr. Wm. Kelly, sole owner of a glove factory which had a value on January 1, 1921, of $50,000, formed a corporation with an authorized capital stock of $100,000, (all of one class) and known as the Kelly Manufacturing Company. He received 800 shares of par value of $100 per share for the glove factory and his goodwill. Herbert Jones and Morris Cohn each paid in $10,000 for 100 shares of stock, apiece, in the new corporation.

QUESTION:

How much taxable profit did Mr. Kelly receive from the sale of his factory?

ANSWER:

None, as Mr. Kelly owned 80% of the outstanding stock of the corporation immediately after the transfer of his property, and was therefore in control of the corporation.

REFERENCE:

Sec. 202 (c): "For the purposes of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized. . . .

"(3) When (a) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (b) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, in control of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

PROBLEM 29

Illustrating the Basis for Determining Gain or Loss on the Sale of Property Received in Exchange for Other Property in Case No Gain or Loss Was Recognized as a Result of the Exchange

FACTS:

Mr. Hiram H. Corby purchased eight thousand shares of Corby Steel Company Stock on April 1, 1912, for $50 per share. This stock was selling for $60 per share on March 1, 1913, and on June 10, 1921, at $90 per share. In connection with a reorganization of the company, Mr. Corby exchanged his entire holdings in the Corby Steel Company on June 10, 1921, for the same number of shares of the Northwestern Steel Company which shares were selling on the day of the exchange at $110 per share. On October 1, 1922, Mr. Corby sold one thousand

shares of Northwestern Steel Company stock thus received for $105 per share. Mr. Corby files his Federal income tax returns on the calendar-year basis.

QUESTION:

What profit or profits, if any, for tax purposes, did Mr. Corby derive from the above mentioned transactions and for what year or years are they to be reported?

ANSWER:

The exchange by Mr. Corby of his stock in the Corby Steel Company for stock in the Northwestern Steel Company, is one which reflects neither profit nor loss for tax purposes. (See Problem 27.) The stock of the Northwestern Steel Company simply takes the place of the stock of the Corby Steel Company The profit upon the sale of 1000 shares of Northwestern Steel Company stock in 1921, is therefore the same as if the same number of shares of Corby Steel Company stock previously owned by Mr. Corby had been sold. In this event, as the March 1, 1913, value was greater than cost, the profit is the difference between the selling price ($105 per share) and such March 1, 1913, value ($60 per share) or $45,000.

REFERENCES:

Sec. 202 (d) (1): "Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e); . . ."

For section 202 (c) see Problems 26, 27 and 28, and for section 202 (e) see Problem 32.

PROBLEM 30

Illustrating the Computation of Taxable Gains on Property Compulsorily or Involuntarily Converted into Cash or its Equivalent

FACTS:

The Pacific Oil Steamship Company, a domestic corporation, in

January, 1921, lost a 10,000-ton tanker by shipwreck. The original cost of the tanker to the Pacific Oil Steamship Company January 1, 1914, was $1,000,000, or $100 per ton. The tanker had depreciated at the rate of 3% per annum. The insurance received on the hull was $2,000,000. The ship was replaced during the year by a 10,000-ton tanker at a cost of $1,500,000, or $150 per ton.

QUESTION:

How should these transactions be reported for income-tax purposes? At what figure should the new vessel be carried on the books of the company to conform to proper income-tax procedure in the event of a subsequent sale?

ANSWER:

Insurance received		$2,000,000
Less:		
Cost of lost tanker	$1,000,000	
Depreciation at 3% per annum	210,000	
Depreciated cost	$790,000	790,000
Gain to be reported as gross income ..		$1,210,000

Against this, however, there is to be allowed a deduction, since the Pacific Oil Steamship Company purchased during the current year a 10,000-ton tanker at a cost of $1,500,000, which is 75% of the proceeds of insurance received. Seventy-five per cent of the gain of $1,210,000 above stated, or $907,500, is deductible from gross income.

In other words 75% of the insurance collected is treated as taking the place of a like proportion of the vessel converted, and therefore reflecting no profit. The other 25% of the insurance collected is treated in the same manner as if a like proportion of the property converted had actually been sold for an amount equal to such 25% of the insurance collected, thus reflecting a profit of $302,500. Thus the property acquired

would be carried on the books of the company at a figure equal to 75% of the depreciated cost ($790,000) of the vessel lost or $592,500. The following entries on the books of the company would reflect the proper treatment in accordance with the foregoing:

(1)

Debit "Cash"	$2,000,000
Credit "Insurance Collected"	2,000,000
To record insurance collected	

(2)

Debit "Insurance Collected"	790,000
Credit "Tankers"	790,000
To record loss of tanker (10,000 tons)	

(3)

Debit "Tankers"	1,500,000
Credit "Cash"	1,500,000
To record purchase of new tanker (10,000 tons)	

(4)

Debit "Insurance Collected"	907,500
Credit "Tankers"	907,500

To reduce the profit resulting from the conversion of the tanker by the amount of the deduction provided for in section 234 (a) (14) of the Revenue Act of 1921 and to adjust the value of the tanker acquired in accordance with the provisions of section 202 (d) (2) of the Revenue Act of 1921.

References:

Sec. 202 (d) (2): "Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in paragraph 12 of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein provided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted."

Sec. 234 (a) (14): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions; . . . (14) If property is compulsorily

or involuntarily converted into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax Acts."

NOTE:—The procedure set forth under the Revenue Act of 1921 in paragraph 12 of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234 for the handling of "replacements" of the kind set forth in this problem is quite dissimilar from the practice employed by the Bureau of Internal Revenue under the Revenue Acts of 1917 and 1918. As a matter of fact, neither the Revenue Act of 1917 nor the Revenue Act of 1918 contained any express provisions for the elimination of profit resulting from the compulsory or involuntary conversion of property into cash or its equivalent. The Treasury Department, however, promulgated a rule for the elimination of such profit and the basis therefor was "replacement in kind," for the determination of which see Article 49 of Regulations 45 Revised. Congress, in enacting section 214 (a) (12) and section 234 (a) (14) of the Revenue Act of 1921, evidently intended to depart from the technical requirements of "replacement in kind." It is to be noted that the provisions of said sections 214 (a) (12) and 234 (a) (14) are retroactive to prior income, war-profits and excess-profits tax Acts as far as practicable.

PROBLEM 31

Illustrating Basis for Determining Gain or Loss From the Sale of Securities Which Were Purchased Within Thirty Days after the Sale of Substantially Identical Property Made At a Loss Subsequent to 3:55 P. M. of Nov. 23, 1921

FACTS:

Mr. Charles A. Brown on April 6, 1918 purchased three hundred shares of Erie Copper Company stock for $115 per share. He sold the above shares on December 5, 1921, for $45 per share. Ten days later, on December 15, 1921, he purchased two hundred shares of the same stock for $45 per share. On March 16, 1922, he sold one hundred shares of the stock thus reacquired, at $55 per share.

Mr. Brown files his income-tax returns on the calendar-year basis.

QUESTION:

What gains or losses is Mr. Brown to report as a result of the above transactions, and for what years?

ANSWER:

As Mr. Brown purchased, December 15, 1921, 200 shares of the Erie Copper Company stock which purchase was within 30 days of the sale (made after the passage of the Revenue Act of 1921—3 : 55 P. M. of November 23, 1921) by him of 300 shares of the same stock, two-thirds of the loss resulting from the sale of such 300 shares is *not* deductible (see Problem 105). Consequently the deductible loss for 1921 resulting from such sale of 300 shares is only $7,000. (300×$70=$21,000. 1/3 of $21,000 =$7,000.) For the purpose of computing the profit or loss resulting from the subsequent sale of the whole or any part of the 200 shares purchased on December 15, 1921, such 200 shares are regarded as costing Mr. Brown $115 per share. Therefore upon the sale on March 16, 1922, of 100 shares

of this stock, Mr. Brown is considered, for tax purposes, to have suffered a loss, deductible in 1922, of the difference between $115 per share and $55 per share, or $60 per share, amounting in the aggregate to $6,000.

REFERENCES:

Sec. 202 (d) (3): "Where no deduction is allowed for a loss or a part thereof under the provisions of paragraph (5) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of."

Sec. 214 (a) (5): ". . . No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed; . . ."

PROBLEM 32

Illustrating Basis for Determining Gain or Loss When Property is Exchanged for Other Property Which Has No Readily Realizable Market Value Together With Money or Other Property Which Has a Readily Realizable Market Value

FACTS:

Mr. James H. Mason on March 16, 1914 purchased a farm near Cleveland, Ohio for $10,000. He decided to retire from the farming business in July, 1921. He therefore accepted an offer to exchange the farm for a small house in the suburbs of Cleveland together with $15,000 in cash. In January, 1922, Mr. Mason sold the house for $2,500. At the time the house was acquired by Mr. Mason, it had no readily realizable market value.

Mr. Mason files his income-tax returns on the calendar-year basis.

QUESTIONS:

Did Mr. Mason derive a profit from the exchange of the farm for the house plus cash? If so, how much? What was the amount of the profit derived from the sale of the house? For what years are the several profits, if any, to be reported?

ANSWERS:

The cash received by Mr. Mason from the exchange of his farm in 1921, is to be offset against the cost of said farm, leaving an excess of $5,000 to be reported as taxable income in 1921. The house acquired by Mr. Mason in 1921, as a result of the exchange of the farm is regarded as having cost Mr. Mason nothing; consequently upon the sale of this house in 1922, the entire proceeds from such sale, or $2,500, are to be reported as income for 1922.

REFERENCE:

Sec. 202 (e): "Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; . . ."

PROBLEM 33

Illustrating Basis for Determining Gain or Loss for the Taxable Year from the Sale of Property Sold under Contract Providing for Payment in Installments

FACTS:

The Taylor Piano Company sold a player piano to Arthur Robinson for $900 on July 1, 1921, payable in monthly installments of $25. The sales contract provided that title to the piano was conveyed to Mr. Robinson immediately upon the initial payment of $25, but subject to a lien for the unpaid portion of the purchase price. The cost of the piano to the Taylor Piano Company amounted to $300. The Taylor Piano Company

received six payments of $25 each on account of this sale, during 1921. The company has been reporting its sales in accordance with the installment method.

QUESTION:

What taxable income should the Taylor Piano Company report on the above sale for the calendar year 1921?

ANSWER:

The Taylor Piano Company should report as income the proportion of each installment payment received during 1921, which the gross profit to be realized bears to the gross contract price, viz:

$600 gross profit to be realized divided by $900, the gross contract price, equals 66⅔ per cent gross profit. Sixty-six and two-thirds per cent of $25, each installment payment, equals $16.66⅔ which is the portion of profit in each installment. This amount multiplied by six, the total number of installments received during 1921, equals $100, which is the total gross profit received during 1921 to be reported as income.

REFERENCES:

Sec. 202 (f): "Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received."

Art. 42, Regulations 62: ". . . The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. . . ."

PROBLEM 34

Illustrating Necessity of Inventories to Clearly Reflect Income

FACTS:

The Advertising Specialty Company, Inc., was organized

during 1921. Its business consisted of the manufacture and sale of advertising novelties. During 1921, the company bought a considerable quantity of raw materials to be made into the finished product. While its sales during 1921 were not very large, the profit on these sales was about 500% over cost. The company files its return on the calendar-year basis. In preparing its return it intends to compute net income by deducting from the sales for the period its total costs including *all* purchases. In other words, it plans to compute its income without taking into consideration the inventory at the close of the year.

QUESTION:

Will the computation of the income in the manner referred to above be acceptable to the Commissioner?

ANSWER:

From the very nature of the business, i. e., the manufacturing and selling of goods, in order to clearly reflect the net income it is necessary to take into consideration the inventories at the beginning and end of the taxable period. Consequently the manner of computing the net income planned by the company will not be acceptable to the Commissioner.

REFERENCE:

Sec. 203: "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Art. 1581, Regulations 62: "Need of Inventories.—In order to reflect the net income correctly, inventories at the beginning and end of each year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include raw materials and supplies on hand that have been acquired for sale, consumption, or use in productive processes, together with all finished or partly finished goods. Only merchandise title to which is vested in the taxpayer should be included in the inventory. Accordingly the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should

exclude from inventory goods sold, title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased, title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery transfer of title to which has not yet been effected.

PROBLEM 35

Illustrating Basis for Computation of Inventory

FACTS:

The Hartford Metal Company was organized in 1921, for the purchase and sale of certain precious metals. It files its first return for the period beginning with the day of its organization in 1921, to and including December 31, 1921. It has on hand at the close of 1921, a substantial inventory. The company desires information as to the basis for the computation of the value of the inventory. Its own preference is to price the goods in inventory on the basis of market at December 31, 1921, regardless of whether or not market was higher or lower than cost.

QUESTION:

What advice should be given the corporation in this connection?

ANSWER:

Inventories are required to be taken by the taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. However, in the past, the Commissioner has given his general sanction to the use of only two methods, to wit: (a) Cost or (b) cost or market whichever is lower. In meritorious cases the Bureau has permitted a deviation from these two methods. If, therefore, the corporation above mentioned believes that its proposed method of inventory taking conforms as nearly as may be to the best account-

ing practice in the trade or business and most clearly reflects the income, it should state its case to the Commissioner and obtain permission to compute its inventory on the basis of market regardless of cost. If the corporation files its return without a request for a ruling as to how its inventory should be prepared, it is required to price its inventory as set forth at the beginning of this paragraph on the basis of either (a) cost or (b) cost or market, whichever is lower.

For the meaning of "cost" and "market" see Articles 1583 given below from Articles 1583 and 1584 of Regulations 62 quoted below.

REFERENCE:

Articles 1582, 1583 and 1584 of Regulations 62 as follows:

Art. 1582. Valuation of inventories.—The Act provides two tests to which each inventory must conform: (1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) it must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with these regulations. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

The basis of valuation most commonly used by business concerns and which meets the requirements of the Revenue Act is (*a*) cost or (*b*) cost or market, whichever is lower. . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less cost of selling whether basis (*a*) or (*b*) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they should be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offerings of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications

indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

In respect to normal goods whichever basis (*a*) or (*b*) is adopted must be applied with reasonable consistency to the entire inventory. Taxpayers were given an option to adopt the basis of either (*a*) cost or (*b*) cost or market, whichever is lower, for their 1920 inventories, and the basis adopted for that year is controlling and a change can now be made only after permission is secured from the Commissioner. Goods taken in the inventory which have been so intermingled that they can not be identified with specific invoices will be deemed to be either (*a*) the goods most recently purchased or produced, and the cost thereof will be the actual cost of the goods purchased or produced during the period in which the quantity of goods in the inventory has been acquired, or (*b*) where the taxpayer maintains book inventories in accordance with a sound accounting system in which the respective inventory accounts are charged with the actual cost of the goods purchased or produced and credited with the value of goods used, transferred, or sold, calculated upon the basis of the actual cost of the goods acquired during the taxable year (including the inventory at the beginning of the year) the net value as shown by such inventory accounts will be deemed to be the cost of the goods on hand. The balances shown by such book inventories should be verified by physical inventories at reasonable intervals and adjusted to conform therewith.

Inventories should be recorded in a legible manner, properly computed and summarized, and should be preserved as a part of the accounting record of the taxpayer. The inventories of taxpayers on whatever basis taken will be subject to investigation by the Commissioner, and the taxpayer must satisfy the Commissioner of the correctness of the prices adopted.

The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with these regulations, viz:

(*a*) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(*b*) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(*c*) Omitting portions of the stock on hand.

(*d*) Using a constant price or nominal value for a so-called normal quantity of materials or goods in stock.

(*e*) Including stock in transit, either shipped to or from the taxpayer, the title of which is not vested in the taxpayer.

Art. 1583. Inventories at Cost.—Cost means:

(1) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(2) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts, approximating a fair interest rate, which

may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(3) In the case of merchandise produced by the taxpayer since the beginning of the taxable year (*a*) the cost of raw materials and supplies entering into or consumed in connection with the product, (*b*) expenditures for direct labor, (*c*) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(4) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are (*a*) farmers and raisers of live stock. . . . , (*b*) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, size or grade, the unit cost of which is substantially alike. . . . , and retail merchants who use what is known as the "retail method" in ascertaining approximate cost. . . . .

Art. 1584. Inventories at Market.—Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases (*a*) of goods purchased and on hand, and (*b*) of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i. e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, which goods must be inventoried at cost. Where no open market exists or where quotations are nominal, due to stagnant market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less proper allowance for selling expense, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained willl not be accepted as reflecting the market.

PROBLEM 36

Illustrating Computation of "Net Loss"

FACTS:

The statement of profit and loss of the Mohegan Oil Company, a West Virginia corporation, for the calendar year 1921, shows the following:

Gross sales	$420,000	
Cost of sales	368,000	
Gross profit on sales		$52,000
Interest		2,000
Dividends from domestic corporations not entitled to benefits of sec. 262		2,000
Total		$56,000
Ordinary and necessary expenses		$82,000
Compensation of officers		24.000
Interest paid		1,000
Repairs		10,000
Taxes (on real estate and not against local benefits)		5,000
Depreciation		10,000
Depletion based on cost		4,000
Net loss on the sale of capital assets and miscellaneous investments		30,000
		$166,000
Loss for the year shown by books		$110,000

Of the interest received, $1,500 is from 6% bonds of the City of Nashville and the entire amount of interest paid, $1,000, is on account of a loan secured to purchase and carry said bonds of the City of Nashville. The other $500 interest received was on

certificates of deposit. An analysis of the items shown under loss on sale of capital assets and miscellaneous investments, shows the following:

Loss on sale of engine purchased in 1917, which was part of the equipment used in the business of the company	$14,000
Loss on sale of stock of the U. S. Steel Corporation purchased in 1916, out of surplus funds	26,000
Total loss	$40,000
Profit on sale of stock of the Allied Chemical Company purchased in 1915, out of surplus funds	10,000
Net loss on these three transactions	$30,000

The property on account of which the depletion of $4,000 is shown above was acquired April 17, 1915, and was not at the time of acquisition a proven tract or lease. However as the result of discoveries made by the Mohegan Oil Co. in 1917, the value of such property within thirty days after discovery was such that on the basis of such discovery value the depletion for 1921 would have been $92,000.

PROBLEM:

Compute the "net loss" of this company for 1921, as "net loss" is defined under section 204 (a).

SOLUTION:

It is to be observed that in the computation of "net loss" which follows, the amount of depletion included among the deductible items is only the depletion based upon cost in accordance with the limitations prescribed by paragraph (9) of section 234. The rule, as interpreted by the author (see Problem 132) is that the depletion based upon discovery value may not exceed the

depletion based upon cost (or March 1, 1913, value) unless the depletion based upon cost (or March 1, 1913, value) is less than the net income from the property subject to depletion (computed without the benefit of a depletion deduction), in which case the depletion based upon discovery value may not exceed such net income.

Deductible items:

Ordinary and necessary expenses	$82,000	
Compensation of officers	24,000	
Repairs	10,000	
Taxes (real estate)	5,000	
Depreciation	10,000	
Depletion allowable	4,000	
Loss on sale of engine	14,000	
Loss on sale of U. S. Steel Co. stock	26,000	
Dividends received from domestic corporations not entitled to benefits of section 262	2,000	$177,000

Less:

(Sec. 204–a–1)	Gross profit on sales		$52,000
" " "	Profit on sale of Allied Chemical Co. stock		10,000
" " "	Dividend received		2,000
" " "	Taxable interest received		500
(Sec. 204–a–2)	Tax-free interest received	$ 1,500	
	Less: Non-deductible interest paid	1,000	500
(Sec. 204–a–3)	Loss on sale of U. S. Steel Co. stock	$26,000	
	Less: Profit on sale of Allied Chem. Co. stock	10,000	16,000

(Sec. 204–a–4) Dividends	2,000	
(Sec. 204–a–5) Depletion based on discovery value	—0—	83,000
"Net loss"		$94,000

REFERENCE:

Sec. 204 (a): "That as used in this section the term 'net loss' means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234, as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceed the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine oil or gas well as is based upon discovery value in lieu of cost."

PROBLEM 37

Illustrating Deductibility by a Corporation of Net Loss of One Year from Taxable Income of a Later Year

FACTS:

The Musical Advertiser, Inc., for the calendar year 1921, has a "net loss," as defined in section 204 (a), of $100,000, Its income-tax return is filed on the calendar-year basis.

QUESTION:

In what year is the 1921 net loss deductible from taxable income?

ANSWER:

In 1922, to the extent that the 1921 net loss is not in excess of the 1922 net income. Any excess over 1922 net income would be deductible in 1923, to the extent of the 1923 net income.

REFERENCE:

Sec. 204 (b): "If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary."

PROBLEM 38

Illustrating Computation of Net Loss of One Year Deductible from Taxable Income of a Later Year in the Case of a Partnership

FACTS:

John and Lill, a domestic partnership, in 1921 suffers a net loss, as defined in section 204 (a), of $2,400. The partnership is composed of Mr. John, who receives one-third of the partnership profits, and Mr. Lill, who receives the other two-thirds. Neither of the partners has income from any source other than from the partnership business. The net income of the business in 1922, was $25,000. Both partnership and partners file returns on the calendar-year basis.

QUESTION:

How is the net loss to be treated?

ANSWER:

In the Revenue Act of 1921 the provision extending the application of the net-loss section to partnerships is the same as that in the Revenue Act of 1918. Consequently, in view of the

procedure under the Revenue Act of 1918, it is reasonable to believe that the 1921 net loss is deductible in the 1922 personal returns of the partners, in the proportion in which they share profits, namely:.

Mr. John (1/3)	$ 800
Mr. Lill (2/3)	1,600

REFERENCES:

Sec. 204 (c): "The benefit of this section shall be allowed to the members of a partnership . . . under regulations prescribed by the Commissioner with the approval of the Secretary."

Sec. 204 deals with "net losses."

PROBLEM 39

Illustrating Computation of Net Loss of One Year Deductible From Taxable Income of a Later Year in the Case of an Estate

FACTS:

For the calendar year 1921, the estate of Mark Mortem, deceased, suffered a net loss, as defined in section 204 (a), of $50,000. The net income in 1922 was $40,000 and in 1923, $100,000. The beneficiaries had no income other than that received from the estate.

QUESTION:

What would be the effect of the net loss?

ANSWER:

$40,000, of the net loss of $50,000, exhausts entirely the net income of the estate for 1922, so that the beneficiaries of the estate have no taxable net income for 1922. The balance of the net loss, or $10,000, reduces the net income of the estate for 1923, to $90,000, upon which basis the beneficiaries of the estate are subject to tax.

REFERENCE:

Sec. 204 (c): "The benefit of this section shall be allowed to

. . . the beneficiaries of an estate or trust . . . under regulations prescribed by the Commissioner with the approval of the Secretary."

PROBLEM 40

Computation of Net Loss in the Case of a Taxpayer Reporting on a Fiscal-Year Basis

FACTS:

The Firmset Furniture Company for its fiscal year ended June 30, 1921, has a net loss of $20,000.

QUESTION:

How is the net-loss deduction applied?

ANSWER:

The proportion of the taxpayer's accounting period falling in 1921 is one-half. Therefore, ½ of $20,000, or $10,000, is the amount of such net loss as computed under the Revenue Act of 1921, which may be charged against the income for the fiscal year ended June 30, 1922; if the income for that year is less than $10,000 the difference may be offset against the income for the fiscal year ended June 30, 1923, to the extent of the net income in that fiscal year.

REFERENCE:

Sec. 204 (d): "If it appears, upon the production of evidence satisfactory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year."

PROBLEM 41

Illustrating Computation of Tax on Individuals—Fiscal Year 1920–1921

FACTS:

(a) George Russell, a citizen of the United States, living on

the last day of his taxable year with his wife and two dependent children both under 18 years of age, has a taxable net income of $4,850 for the fiscal year ending September 30, 1921.

(b) Robert Wells, a citizen of the United States, living on October 31, 1921 with his wife and two-year-old child, has a taxable net income of $5,010, for the fiscal year ending October 31, 1921.

(c) Wm. Kerr, a citizen of the United States, at the end of his taxable year was living with his wife, and was the chief support of his physically defective father. The taxpayer has a net income of $48,000 for the fiscal year ending November 30, 1921. In arriving at this income he deducted $5,000, as a loss sustained in selling shares of stock, which were sold on November 28, 1921, but which he repurchased the next day and still holds.

(d) Charles Roberts, a citizen of the United States living with his wife on the last day of his taxable year, has a net income of $24,000, for the fiscal year ending October 31, 1921.

QUESTION:

What is the amount of Federal income tax assessable against each of the above individuals?

ANSWER:

(a) Net Income	$4,850.00
Less: Personal exemption (1918 law)	2,400.00
Balance, taxable at 4%	$2,450.00
Tax at 4%, as per 1918 Law	98.00
1920 portion (Oct. 1, 1920, to Dec. 31, 1920), 3/12	24.50
Net Income	$4,850.00
Less: Personal exemption (1921 Law)	3,300.00
Balance, taxable at 4%	$1,550.00
Tax at 4% as per 1921 Law	62.00

1921 portion (Jan. 1, 1921 to Sept. 30, 1921), 9/12 of $62	$46.50
1920 portion (shown above)	24.50
Total tax assessable	$71.00

(b) Net income	$5,010.00
Less: Personal exemption (1918 Law)	2,200.00
Balance, taxable at 4%	$2,810.00
Tax at 4%	$112.40
Surtax (1918 Law)	.10
Tax as per 1918 Law	$112.50
1920 portion (Nov. 1, 1920 to Dec. 31, 1920) 2/12	18.75
Net income	$5,010.00
Less: Income to be reported as tax (1921 Law)	10.00
Balance	$5,000.00
Less: Personal exemption (1921 Law)	2,900.00
Taxable at 4%	$2,100.00
Tax at 4% as per 1921 Law	$84.00
Surtax (1921 Law)	.10
Income to be reported as tax (1921 Law)	10.00
Tax as per 1921 Law	$94.10
1921 portion(Jan. 1, 1921, to Oct. 31, 1921) 10/12 of $94.10	$78.42
1920 portion (see above)	18.75

Total tax assessable	$97.17

(c) Net income	$48,000.00
Less: Personal exemption (1918 Law)	2,200.00
Balance	$45,800.00
Tax at 4% (on $4,000)	$ 160.00
Tax at 8% (over $4,000)	3,344.00
Surtax	5,050.00
Tax as per 1918 Law	$8,554.00
1920 portion (Dec. 1, 1920, to Dec. 31, 1920) 1/12	712.83
Net income reported	$48,000.00
Plus: Item not allowed as deduction (1921 Law)	5,000.00
Taxable net income (surtax)	$53,000.00
Less: Personal exemption (1921 Law)	2,400.00
Balance taxable (normal)	$50,600.00
Tax at 4% (on $4,000)	$ 160.00
Tax at 8% (over $4,000)	3,728.00
Surtax	6,240.00
Tax as per 1921 Law	$10,128.00
1921 portion (Jan. 1, 1921, to Nov. 30, 1921) 11/12 of $10,128	$9,284.00
1920 portion (see above)	712.83
Total tax assessable	$9,996.83

(d) Net income	$24,000.00
Less: Personal exemption (1918 Law)	2,000.00
Balance	$22,000.00
Tax at 4% (on $4,000)	$ 160.00
Tax at 8% (over $4,000)	1,440.00
Surtax at 1918 rates	1,090.00
Tax under 1918 Law	$2,690.00
1920 portion (Nov. 1, 1920, to Dec. 31, 1920) $\frac{2}{12}$	448.33
Net income	$24,000.00
Less: Personal exemption (1921 Law)	2,000.00
Balance	$22,000.00
Tax at 4% (on $4,000)	$160.00
Tax at 8% (over $4,000)	1,440.00
Surtax at 1921 rates	1,090.00
Total tax as per 1921 Law	$2,690.00
1921 portion (Jan. 1, 1921, to Oct. 31, 1921) $\frac{10}{12}$	$2,241.67
1920 portion (see above)	448.33
Total tax assessable	$2,690.00

Reference:
Sec. 205 (a): (Quoted under Problem 44)

PROBLEM 42

Illustrating Adjustments for Payments of Tax Made Prior to the Passage of 1921 Act on Fiscal Year 1920–1921

FACTS:

(a) John Burke, having a fiscal year ending June 30, 1921, paid his tax in full, computed under the 1918 Act, September 15, 1921. Under the 1921 Act Mr. Burke's tax liability for his fiscal year is $18 less than the amount paid.

(b) William Miller, having a fiscal year ending July 31, 1921, paid his first installment of tax October 15, 1921. Recomputation after the passage of the 1921 Act shows that he overpaid the installment by $5.25.

(c) Peter Wood, having a fiscal year ending July 31, 1921, computed his tax under the 1918 Act. Upon the passage of the 1921 Act, a recomputation showed that he still owed $500, on his first installment, which installment he had paid when due October 15, 1921.

QUESTION:

How are the payments by the above individuals to be adjusted?

ANSWER:

(a) John Burke, having paid his tax in full, may file a claim for refund of the overpayment of $18.

(b) William Miller may file a claim for credit for $5.25 and withhold this amount as an offset against a later installment of tax as computed in accordance with the 1921 Act.

(c) Peter Wood must make a new return, and finding $500 due on his first installment must pay same immediately.

REFERENCE:

Sec. 205 (a) (Quoted under Problem 44)

PROBLEM 43

Illustrating Computation of Tax on Individuals—Fiscal Year 1921–1922

FACTS:

(a) Charles Owen, a married man living on October 31, 1922 with his wife and his two children both under 18 years of age, shows a taxable net income of $26,000 for the fiscal year ending on that date.

(b) Fred Cook, a married man living with his wife on the last day of his taxable year, shows a taxable net income of $5,000, for the fiscal year ending June 30, 1922.

(c) John Ross, single, shows a taxable net income of $46,000 for the fiscal year ending August 31, 1922. Included in this income is a capital net gain of $10,000, realized in July, 1922.

(d) Edward Moore, a married man, living with his wife on September 30, 1922, has a taxable net income of $6,000 for the fiscal year ending on that date.

All of the above taxpayers are citizens of the United States.

QUESTION:

What is the income tax assessable against each of the above individuals for the fiscal years indicated?

ANSWER:

(a)	Net income	$26,000.00
	Less personal exemption	2,800.00
	Balance	$23,200.00
	Tax @ 4% (on $4,000)	$ 160.00
	Tax @ 8% (over $4,000)	1,536.00
	Surtax (1921 rates)	1,310.00
	Total tax 1921 rates	$ 3,006.00

1921 portion (Nov. 1, 1921, to Dec. 31, 1921) 2/12	$ 501.00
Surtax (1922 rates)	980.00
Total tax 1922 rates	$2,676.00
1922 portion (Jan. 1, 1922, to Oct. 31, 1922 10/12	$2,230.00
1921 portion (as above)	501.00
Total tax assessable	$2,731.00
(b) Net income	$5,000.00
Exemption	2,500.00
Balance	2,500.00
Tax @ 4%	100.00
Since the rates for 1921 and 1922 are the same for $5,000 and under, and there is no surtax on $5,000 in either year, the total tax for the fiscal year will be	$100.00
(c) Net income	$46,000.00
Less personal exemption	1,000,00
Balance	$45,000.00
Tax @ 4% (on $4,000)	160.00
Tax @ 8% (over $4,000)	3,280.00
Surtax (1921 rates)	4,610.00
Total tax (1921 rates)	$8,050.00
Surtax (1922 rates)	4,100.00
Total tax (1922 rates; ordinary method) ...	7,540.00
Total tax (1922 rates, computed under Sec. 206–b)	6,190.00
1921 portion (Sept. 1, 1921. to Dec 31, 1921) 4/12 of $8,050	$2,683.33

1922 portion (Jan. 1, 1922, to Aug. 31, 1922) 8/12 of $6,190	$4,126.67
Total tax assessable	$6,810.00
(d) Net income	$6,000.00
Less personal exemption	2,000.00
Balance	$4,000.00
Tax @ 4%	$160.00
Surtax (1921)	10.00
Total tax (1921 rates)	$170.00
" " (1922 rates, no surtax on $6,000)	160.00
1921 portion (Oct. 1, 1921, to Dec. 31, 1921) 3/12 of $170	$ 42.50
1922 portion (Jan. 1, 1922, to Sept. 30, 1922) 9/12 of $160	120.00
Total tax assessable	$162.50

References:

Sec. 205 (b) (Quoted under Problem 44)
For computation of case under section 206 (b) see Problem 52.

PROBLEM 44

Illustrating Computation of Income and Profits Taxes for a Fiscal Year Ended in 1921

Facts:

The Wilson Woodcraft Corporation for its fiscal year ended May 31, 1921, had a taxable net income of $90,000. Its invested capital for the year was $400,000. A return was filed August

15, 1921, showing a tax liability of $20,700. One-fourth of the tax was paid when the return was filed, and a second equal installment was paid on November 15th.

PROBLEM:

Compute the tax for the fiscal year and show the amount of tax still due.

SOLUTION:

Computation of excess-profits tax:

Excess-profits credit, $3,000+8% of $400,000=$35,000

	Net income	Credit	Balance	Rate	Tax
First bracket (not over 20% of invested capital)..	$80,000	$35,000	$45,000	20%	$ 9,000
Second bracket ...	10,000	0	10,000	40%	4,000
	$90,000	$35,000	$55,000		$13,000

The excess-profits tax, under both the 1918 Act and the 1921 Act, for the full twelve months is $13,000. The excess-profits tax, then, for the 7 months in 1920 would be 7/12 of $13,000, or $7,583.33, and the excess-profits tax for the 5 months in 1921 would be 5/12 of $13,000, or $5,416.67.

Computation of the income tax:

1920 RATES	1921 RATES
$90,000	$90,000
13,000	13,000
$77,000	$77,000
Exemption . 2,000	
$75,000 @ 10%=$7,500	$77,000 @ 10%=$7,700

$\frac{7}{12}$ of \$7,500=\$4,375, income tax for 7 months in 1920.
$\frac{5}{12}$ of \$7,700=\$3,208.33 income tax for 5 months in 1921.

. . . .

Total tax:	Excess-profits tax, 1920	....	\$7,583.33	
	" " " 1921	....	5,416.67	
	Income " 1920	....	4,375.00	
	" " 1921	....	3,208.33	\$20,583.33
	Tax paid	....		10,350.00
	Additional tax due	....		\$10,233.33

References:

Sec. 205. (a): "That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title [1] for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under Title II [1] of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period.

"Any amount paid before or after the passage of this Act on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252."

Sec. 236: "That for the purpose only of the tax imposed by section 230 [2] there shall be allowed the following credits . . . (c): The amount of any war-profits and excess-profits taxes imposed by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

"(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (a) of section 205, and the portion of the

war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205."

Sec. 301. (a): "That in lieu of the tax imposed by Title III [3] of the Revenue Act of 1918, but in addition to the other taxes imposed by this Act, there shall be levied, collected and paid for the calendar year 1921 upon the net income of every corporation (except corporations taxable under subdivision (b) of this section) a tax equal to the sum of the following:

First Bracket.

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

Second Bracket.

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital."

Sec. 335 (a) (Quoted under Problem 334)

Art. 1622, Regulations 62: "Fiscal year ending in 1921.—The method provided for computing the tax for a fiscal year beginning in 1920 and ending in 1921, is as follows: (*a*) The tax attributable to the calendar year 1920 is found by computing the income of the taxpayer and the tax thereon in accordance with Title II [1] of the Revenue Act of 1918 as if the fiscal year was the calendar year 1920, and determining the proportion of such tax which the portion of such period falling within the calendar year 1920 is of the entire period; (*b*) the tax attributable to the calendar year 1921 is found by computing the income of the taxpayer and the tax thereon in accordance with the present statute as if the fiscal year was the calendar year 1921, and determining the proportion of such tax which the portion of such period falling within the calendar year 1921 is of the entire period; and (*c*) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1920 and the tax attributable to the calendar year 1921."

Art. 1623, Regulations 62: "Credits in the case of fiscal year ending in 1921.—In computing the tax attributable to the calendar year 1920 the net income computed for the entire period under Title II [1] of the Revenue Act of 1918 shall be credited with the amount of the excess-profits tax computed for the entire period under Title III [3] of the Revenue Act of 1918. In computing the tax attributable to the calendar year 1921 the net income computed for the entire period under the present statute shall be credited with the amount of the excess-profits tax computed for the entire period under Title III [3] of this statute. See section 236 of the statute and article 591. Amounts previously paid by the taxpayer on account of the income tax for such fiscal year shall be credited towards the payment of the income tax imposed for such fiscal year by the present statute. Any excess

shall be credited or refunded in accordance with the provisions of section 252. See articles 1031 and 1034-1036."

Art. 952, Regulations 62: "Fiscal year of corporation ending in 1921.—The method provided for computing the tax[4] for a fiscal year beginning in 1920 and ending in 1921 is as follows: (a) The tax[4] attributable to the calendar year 1920 is found by computing the income of the taxpayer and the tax thereon in accordance with the Revenue Act of 1918 as if the fiscal year was the calendar year 1920, and determining the proportion of such tax which the number of months falling within the calendar year 1920 is of the number of months in the entire period; (b) the tax[4] attributable to the calendar year 1921 is found by computing the income of the taxpayer and the tax thereon in accordance with the present statute as if the fiscal year was the calendar year 1921, and determining the proportion of such tax which the number of months falling within the calendar year 1921 is of the number of months in the entire period; and (c) the tax[4] for the fiscal year is found by adding the tax attributable to the calendar year 1920 and the tax attributable to the calendar year 1921."

NOTE:

In the computation given above, the commendable method outlined by the Bureau in Regulations 62 has been followed, which method conforms with the procedure outlined in Treasury Decision 2796 with reference to the computation of the tax in the case of a fiscal year ended in 1918. The language of the 1921 Act is however quite different from that of the 1918 Act in respect to the computation of the tax in the case of a fiscal year. The following computation, although showing a result possibly not intended by Congress, is offered as one conforming more nearly to the language of the statute:

Computation of income tax:

1920 RATES		1921 RATES	
Surtax (7 mos.)	7,583.33	$90,000.00	Surtax (5 mos.)
(as above)	$90,000.00	5,416.67	(as above)
	$82,416.67	$84,583.33	@ 10% = $8,458.33

1 Refers to income tax.
2 Section 230 imposes the tax on corporations.
3 Refers to profits tax.
4 Article 952 relates only to the profits tax.

1920 Rates		1921 Rates
Exemption	2,000.00	
$80,416.67 @ 10% =	$8,041.67	

7/12 of $8,041.67=$4,690.97, income tax for 7 months in 1920.
5/12 of $8,458.33=$3,524.17, income tax for 5 months in 1921.

Total tax: Excess-profits tax, 1920	$7,583.33	
" " " 1921	5,416.67	
Income " 1920	4,690.97	
" " 1921	3,524.17	$21,215.14
Tax paid		10,350.00
Additional tax due		$10,865.14

PROBLEM 45

Illustrating Computation of Income and Profits Tax for a Fiscal Year Ended in 1922

Facts:

The Warren Gardening Company in its fiscal year ended October 31, 1922, had a taxable net income of $15,000. Its invested capital for the year is $65,000.

Problem:

Compute the tax liability.

Solution:

Computation of excess-profits tax:

Excess-profits credit, $3,000+8% of $65,000, a total of $8,200.

Bracket	Net Income	Credit	Balance	Rate	Tax
1	$13,000	$8,200	$4,800	20%	$ 960

2	2,000	0	2,000	40%	800
	$15,000	$8,200	$6,800		$1,760

Since only $2/12$ of the fiscal year occurs prior to January 1, 1922, the excess-profits tax to be assessed will be $2/12$, or $1/6$, of $1,760 which is $293.33.

Computation of income tax and total tax:

			Tax
Net income		$15,000	
Excess-profits tax (for 12 months)	$ 1,760		
Exemption	2,000	3,760	
Taxable at 10%		$11,240	
Tax for $2/12$ year (2 months in 1921)			187.33
Excess-profits tax (2 months in 1921) (see above)			293.33
Tax on $15,000, less exemption $2,000 at 12½% for $10/12$ year (10 months in 1922)			1,354.17
Total tax for fiscal year			$1,834.83

REFERENCES:

Sec. 205 (b): "If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this title (as in force on December 31, 1921) at the rates for the calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922 is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2)."

Sec. 236 (c) (2): "In the case of a corporation which makes return for a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdivision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (b) of section 205."

Sec. 301 (a)—See Problem 44 for quotation.
Sec. 302 — " " 281 " "
Sec. 335 (b)— " " 335 " "

Art. 1624, Regulations 62: "Fiscal year ending in 1922.—in computing the tax for a fiscal year beginning in 1921 and ending in 1922 the procedure is as follows: (a) The tax attributable to the calendar year 1921 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as in force on December 31, 1921, as if the fiscal year was the calendar year 1921 and determining the proportion of such tax which the portion of such period within the calendar year 1921 is of the entire period; before calculating the tax the net income computed for the entire period shall be credited with the excess-profits tax computed for the entire period under Title III[1] of this statute as if the fiscal year was the calendar year 1921; (*b*) the tax attributable to the calendar year 1922 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as in force on January 1, 1922, as if the fiscal year was the calendar year 1922, and determining the proportion of such tax which the portion of such fiscal year falling within the calendar year 1922 is of the entire period; and (*c*) the tax for the fiscal year is found by adding the tax attributable to the calendar year 1921 to the tax attributable to the calendar year 1922. . . . . ."

Art. 954, Regulations 62: "Fiscal year of corporation ending in 1922.—The method provided for computing the tax[2] for a fiscal year beginning in 1921 and ending in 1922 is as follows: The tax[2] attributable to the calendar year 1921 is found by computing the income of the taxpayer and the tax thereon in accordance with the statute as if the fiscal year was the calendar year 1921, and determining the proportion of such tax which the number of months falling within the calendar year 1921 is of the number of months in the entire period. . . ."

NOTE:

As in Problem 44, illustrating the computation of the tax in the case of a fiscal year ending in 1921, the above computation is made in accordance with the method outlined in Regulations 62, which method is unquestionably more equitable than that shown below. The following computation, however, would appear to be more nearly in conformity with the language of the statute:

Computation of income tax and total tax:

Net income $15,000.00

[1] Refers to the profits tax.

[2] Article 954 refers only to the profits tax.

			Tax
Excess-profits tax (as above) .	$ 293.33		$ 293.33
Exemption (in the case of corporations whose net income is $25,000 or less)	2,000.00	2,293.33	
Balance subject to 10% tax		$12,706.67	
Tax for 2/12 year			211.78
Tax on $15,000 at 12½% for 10/12 year (1922) (exemption $2,000)			1,354.17
Total tax for fiscal year			$1,859.28

PROBLEM 46

Illustrating Computation of Tax Against a Personal Service Corporation—Fiscal Year 1921–1922

FACTS:

The Brown & Wilson Company, a domestic personal service corporation, shows a taxable net income of $64,000 for the fiscal year ending June 30, 1922.

QUESTION:

What is the income tax assessable against the above corporation?

ANSWER:

Net income	$64,000
Income tax at 12½%	8,000
Income tax assessable (½ of above)	4,000

REFERENCE:

Sec. 205 (b): "If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be . . . (2) the same proportion of a tax for the entire period computed under this title (as in force on

January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922 is of the entire period: *Provided,* That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2)."

PROBLEM 47

Illustrating Capital Gain

FACTS:

The H. O. Kerr Tool Company in 1922 sells for $30,000 a warehouse which it had purchased in 1915 for $15,000. The depreciation on the building in the meantime was $2,000. The expense of making the sale amounted to $500.

PROBLEM:

Compute the capital gain on the transaction.

SOLUTION:

Selling Price		$30,000
Cost	$15,000	
Depreciation	2,000	13,000
		$17,000
Capital deduction		500
Capital gain		$16,500

REFERENCE:

Sec. 206 (a): "That for the purpose of this title: (1) The term 'capital gain' means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921."

PROBLEM 48

Illustrating Capital Loss

FACTS:

The John G. Ward Dry Goods Company in January, 1922,

sold for $30,000 a store building which the company purchased in January, 1900, at a cost of $80,000. The building was estimated to have a 50-year life. The market value of the building on March 1, 1913, was $74,000. The depreciation written off on the books of the company was $1,600 for each year in the period from 1900 to 1912, inclusive, and $2,000 for each year in the period from 1913 to 1920, inclusive.

The expenses of the sale were borne by the vendee.

PROBLEM:

Show the capital loss incurred in the transaction.

SOLUTION:

Cost		$80,000.00
Depreciation:		
1900–1912, 13 years @ $1,600	$20,800	
1913–1921, 9 years @ $2,000	18,000	38,800.00
Balance		$41,200.00
March 1, 1913 value		$74,000.00
Depreciation, March 1, 1913, to December 31, 1921, 8⅚ years @ $2,000		17,333.33
		$56,666.67

The $41,200.00, being lower than the $56,666.67, is used as the basis for computing the loss.

Cost less depreciation	$41,200.00
Selling price	30,000.00
Capital loss	$11,200.00

REFERENCE:

Sec. 206 (a): "That for the purpose of this title: . . . (2) The term 'capital loss' means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921;"

PROBLEM 49

Illustrating Capital Deductions and Capital Net Gain

FACTS:

The Moore Malt Company in 1922, sells a store building at a loss of $11,200. The company also sells a warehouse, realizing thereon a profit of $17,000, offset in part, however, by an expense of $500, in effecting the sale.

QUESTION:

What is the capital deduction, and what is the capital net gain?

ANSWER:

The capital deduction is $500.

The capital net gain is computed as follows:

Profit on sale of warehouse		$17,000
Loss on sale of store building	$11,200	
Capital deductions	500	11,700
Capital net gain		$ 5,300

REFERENCE:

Sec. 206 (a): "That for the purpose of this title . . . (3) the term 'capital deductions' means such deductions as are allowed under this title for the purpose of computing net income and properly allocable to or chargeable against items of capital gain as defined in this section; (4) the term 'capital net gain' means the excess of the total amount of capital gain over the sum of the capital deductions and capital losses."

PROBLEM 50

Illustrating Ordinary Net Income as Distinguished from Capital Gain

FACTS:

The Pica Printing Company, job printers, in 1922, has in-

come from its printing operations amounting to $200,000. The expense of carrying on these operations is $150,000, leaving net profit of $50,000, from that source. The company has no other income or expense except a capital gain of $12,000 realized on the sale of a paper factory which the company had built and had operated for a number of years. The total net income of the company was, therefore, $62,000. All the above amounts were arrived at by computations made in accordance with the provisions of the Revenue Act of 1921.

QUESTION:

What is the ordinary net income of the company?

ANSWER:

$50,000.

REFERENCE:

Sec. 206 (a) (5): "The term 'ordinary net income' means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions."

PROBLEM 51

Illustrating the Meaning of Capital Assets as that Term is Used in Connection with Capital Gain or Capital Loss

FACTS:

In an appraisal of the properties of H. J. Werner, a wholesale grocer, the following assets were listed:

Name of Asset	*Year Acquired*	*Particulars*
1. Warehouse #1	1905	Used for storing groceries
2. Warehouse #2	1921	" " " "
3. Trucks	1915	" " hauling "
4. Retail store bldg	1915	Built for purpose of conducting retail business.

5. " " "	1918	Acquired in payment of debt; held for sale.
6. Vacant lot	1921	Acquired in payment of debt; held for sale.
7. Inventory ...	1919–20–21	Groceries.
8. Residence	1910	Mr. Werner's home.
9. Stocks and bonds ...	1918	Held for investment.
10. Automobile	1916	For use for business purposes.
11. "	1918	For Mr. Werner's personal use.
12. Accounts Receivable	1919–20–21	Arising out of the normal conduct of Mr. Werner's business.

PROBLEM:

Show which of the above if disposed of in 1921 would be considered capital assets for the purpose of computing capital gain or capital loss.

ANSWER:

Nos. 1, 3, 4, 5, 9, and 10 would be considered capital assets.

Nos. 2 and 6 would not be so considered because they had been held less than two years.

No. 7 would not be considered a capital asset because it constitutes stock in trade.

Nos. 8 and 11 are held for the personal use of the taxpayer.

No. 12 is not held for profit or investment.

REFERENCE:

Sec. 206 (a) (6): "The term 'capital assets' as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year."

PROBLEM 52

Illustrating Computation of Tax of an Individual in Case Capital Net Gain Included in 1922 Net Income—Application of the Minimum Limitation on Total Tax Equal to 12½% of Net Income

FACTS:

Allen Hartford, a citizen of the United States, engaged in farming, sells his farm in 1922 for $150,000, which in 1914 had cost $45,000. There are no buildings on the farm and no depreciation has been deducted. Expenses in connection with completing the sale totaled $1,000, leaving a capital net gain of $104,000. Mr. Hartford had ordinary net income of $6,000. His exemption is $2,000, and he reports on the calendar-year basis.

PROBLEM:

Compute the tax for 1922.

SOLUTION:

Capital net gain		$104,000
Ordinary net income		6,000
Total (subject to surtax)		$110,000
Exemption		2,000
Balance (subject to normal tax)		$108,000
Normal tax:		
	$ 4,000 @ 4%	$ 160
	104,000 @ 8%	8,320
	$108,000	$ 8,480
Surtax on $110,000		$27,260

The total tax liability by this computation is $8,480, plus $27,260, or $35,740.

The computation under the option provided by Sec. 206 follows:

Ordinary net income	$ 6,000
Exemption	2,000
Balance (subject to normal tax)	$ 4,000
Normal tax ($4,000 @ 4%)	$ 160
Surtax	None
12½% of capital net gain (12½% of $104,000.00)	$13,000
Income tax, as above	160
Surtax, as above	None
Total	$13,160
12½% of total net income ($110,000)	$13,750

This amount, $13,750, being less than the $35,740, arrived at by the first computation, represents Mr. Hartford's total tax liability. The $13,160, can not be used, since it is lower than the minimum limitation set in Sec. 206 (b).

REFERENCES:

Sec. 206 (b): (Quoted under Problem 58)

PROBLEM 53

Illustrating the Computation of the Tax of a Corporation in 1922 Where Capital Net Gain Included in Income

FACTS:

The gross income (all taxable) of the Green Grocery

Company for the calendar year 1922 is $400,000. Included in this amount is $150,000 capital net gain.

The total business expenses (all deductible) of the company for the year were $225,000.

QUESTION:

What is the tax for the year?

ANSWER:

Gross income of company	$400,000
Deductions	225,000
Net income	$175,000
Tax at 12½%	21,875

REFERENCES:

Sec. 206 (b) (Quoted under Problem 58)
Sec. 230 (b) (Quoted under Problem 202)

NOTE:

The portion of the law providing for the special taxation of capital net gains by express provision of the statute does not apply to corporations.

PROBLEM 54

Illustrating Taxability of Capital Net Gain of a Partnership, Estate or Trust

FACTS:

(1) The Arthur-Bennett Company, a partnership, in the calendar year 1922 has ordinary net income amounting to $60,000, and a capital net gain of $40,000. The partnership is composed of Mr. Arthur and Mr. Bennett, Mr. Arthur taking one-fifth of all profits and Mr. Bennett four-fifths.

(2) A certain estate, one-fifth of the income of which accrues to a Mr. Martin, has a total net income in the calendar year 1922

amounting to $100,000, of which 60 per cent is ordinary net income and the balance is capital net gain.

(3) Under the terms of a certain trust, a Mr. Hope receives 20% of all the income of said trust. In the calendar year 1922, the total taxable net income of the trust is $100,000, of which $40,000, was capital net gain and the balance was ordinary net income.

QUESTION:

What effect, if any, will the fact that 40 per cent of the income of each of the above is capital net gain, have on the tax liability of Messrs. Arthur, Martin and Hope, who receive 20 per cent of income of the partnership, estate, and trust, respectively?

ANSWER:

The fact that a portion of the net income in each case was capital net gain will (under regulations to be prescribed by the Commissioner) be taken into consideration in determining the tax liability of the individual recipients. If, for instance, Mr. Arthur had ordinary net income amounting to $30,000, in addition to his $20,000 share in the partnership profits, his tax liability will be based on a total net income of $50,000, of which it is probable that $8,000 (40% of the $20,000) will be considered capital net gain, and the option provided for in section 206 (b) allowed accordingly.

Similar methods of computation will be applied in the cases of Mr. Arthur and Mr. Hope.

REFERENCE:

Sec. 206 (c): "In the case of a partnership or of an estate or trust, the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections 218 and 219, but at the rates and in the manner provided in subdivision (b) of this section."

PROBLEM 55

Illustrating Computation of Normal Tax

FACTS:

L. E. Clear, a citizen of the United States, in the calendar year 1921 after applying all credits, including his personal exemption of $2,400, has a net income of $45,000.

PROBLEM:

Compute his normal tax liability.

SOLUTION:

$4,000 at 4%	$ 160
41,000 at 8%	3,280
Total normal tax	$3,440

REFERENCE:

Sec. 210: "That in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided,* That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum."

NOTE:

It should be observed that the above covers only the normal tax liability. For an illustration of the computation of the surtax, see the following problem.

PROBLEM 56

Illustrating Computation of Surtax

FACTS:

L. E. Clear, a resident of Oak Park, Illinois, in the calendar

year 1921, after applying all credits, has ordinary net income of $51,400, subject to surtax.

PROBLEM:

1. Compute the surtax liability for 1921.

2. Assuming that in the calendar year 1922, Mr. Clear's income subject to surtax will be $210,000, and that his income will all be derived from his ordinary business transactions, compute the surtax for that year.

SOLUTION:

1. Reference to the table below shows that in 1921 for an income of $50,000, the total surtax is $5,510, and that the rate applying to the next $2,000, is 24%. That rate, 24%, must therefore be applied to so much of Mr. Clear's income as exceeds $50,000, or $1,400. Twenty-four per cent of $1,400, is $336, which added to the $5,510 shown above, results in a total surtax of $5,846.

2. For 1922 the table indicates a total surtax of $70,960, for an income of $200,000. The rate for all amounts above $200,000 is 50%. This rate applied to the remaining $10,000, in Mr. Clear's income results in a tax of $5,000, which added to the $70,960, shown above results in a total surtax for 1922 amounting to $75,960.

REFERENCE:

Sec. 211 (a) (1) and (2).

NOTE:

The following table shows the surtax on the net incomes of the amounts specified in the section of the statute above referred to. In each instance the first figure of net income in the net income column is to be excluded and the second figure included. The percentages given opposite apply to the excess of income over the first figure in the net income columns, and the sums in the columns following the percentage columns represent the tax on the entire difference between the first figure and the second figure in the net income columns. The "Total Surtax"

columns give the total surtax for 1921 and 1922, respectively, on a net income equal to the second figure in the net income columns.

Net Income	*Per Cent*	*1921 Surtax*	*Total Surtax*	*Per Cent*	*1922 Surtax*	*Total Surtax*
$ 5,000 to 6,000	1	$ 10	$ 10	0	$ 0	$ 0
6,000 to 8,000	2	40	50	1	20	20
8,000 to 10,000	3	60	110	1	20	40
10,000 to 12,000	4	80	190	2	40	80
12,000 to 14,000	5	100	290	3	60	140
14,000 to 16,000	6	120	410	4	80	220
16,000 to 18,000	7	140	550	5	100	320
18,000 to 20,000	8	160	710	6	120	440
20,000 to 22,000	9	180	890	8	160	600
22,000 to 24,000	10	200	1,090	9	180	780
24,000 to 26,000	11	220	1,310	10	200	980
26,000 to 28,000	12	240	1,550	11	220	1,200
28,000 to 30,000	13	260	1,810	12	240	1,440
30,000 to 32,000	14	280	2,090	13	260	1,700
32,000 to 34,000	15	300	2,390	15	300	2,000
34,000 to 36,000	16	320	2,710	15	300	2,300
36,000 to 38,000	17	340	3,050	16	320	2,620
38,000 to 40,000	18	360	3,410	17	340	2,960
40,000 to 42,000	19	380	3,790	18	360	3,320
42,000 to 44,000	20	400	4,190	19	380	3,700
44,000 to 46,000	21	420	4,610	20	400	4,100
46,000 to 48,000	22	440	5,050	21	420	4,520
48,000 to 50,000	23	460	5,510	22	440	4,960
50,000 to 52,000	24	480	5,990	23	460	5,420
52,000 to 54,000	25	500	6,490	24	480	5,900
54.000 to 56,000	26	520	7,010	25	500	6,400
56,000 to 58,000	27	540	7,550	26	520	6,920
58,000 to 60,000	28	560	8,110	27	540	7,460
60,000 to 62,000	29	580	8,690	28	560	8,020
62,000 to 64,000	30	600	9,290	29	580	8,600
64,000 to 66,000	31	620	9,910	30	600	9,200
66,000 to 68,000	32	640	10,550	31	620	9,820
68,000 to 70,000	33	660	11,210	32	640	10,460
70,000 to 72,000	34	680	11,890	33	660	11,120
72,000 to 74,000	35	700	12,590	34	680	11,800
74,000 to 76,000	36	720	13,310	35	700	12,500
76,000 to 78,000	37	740	14,050	36	720	13,220
78,000 to 80,000	38	760	14,810	37	740	13,960
80,000 to 82,000	39	780	15,590	38	760	14,720
82,000 to 84,000	40	800	16,390	39	780	15,500
84.000 to 86,000	41	820	17,210	40	800	16,300
86,000 to 88,000	42	840	18,050	41	820	17,120
88,000 to 90,000	43	860	18,910	42	840	17,960
90,000 to 92,000	44	880	19,790	43	860	18,820
92,000 to 94,000	45	900	20,690	44	880	19,700
94,000 to 96,000	46	920	21,610	45	900	20,600
96,000 to 98,000	47	940	22,550	46	920	21,520
98,000 to 100,000	48	960	23,510	47	940	22,460

Net Income	*Per Cent*	*1921 Surtax*	*Total Surtax*	*Per Cent*	*1922 Surtax*	*Total Surtax*
100,000 to 150,000	52	26,000	49,510	48	24,000	46,460
150,000 to 200,000	56	28,000	77,510	49	24,500	70,960
200,000 to 300,000	60	60,000	137,510	50	50,000	120,960
300,000 to 500,000	63	126,000	263,510	50	100,000	220,960
500,000 to 1,000,000	64	320,000	583,510	50	250,000	470,960
1,000,000 up	65	......	......	50	......	......

The surtax for any amount of net income not shown in the above table is computed by adding to the total surtax for the largest amount shown which is less than the income, the surtax upon the excess over that amount at the rate indicated in the table. For example, if the amount of net income is $63,128, the surtax for 1921 is the sum of $8,690, (the surtax upon $62,000, as shown by the table) plus 30 per cent of $1,128 or $338.40, making a total surtax of $9,028.40. In 1922 the surtax on the same net income would be the sum of $8,020, (the surtax upon $62,000, as shown by the table) plus 29 per cent of $1,128, or $327.12, making a total surtax of $8,347.12.

PROBLEM 57

Illustrating Computation of the Surtax In the Case of Profits Derived From the Sale of a Mine in 1922

FACTS:

E. D. Colvin in 1922 sells for $600,000, an Arizona silver mine which he had acquired the previous year for $150,000. The increase in value of the mine was demonstrated by discovery work done by Mr. Colvin. In addition to the net profit of $450,000, on the sale of the mine, Mr. Colvin had other taxable net income of $3,600.

QUESTION (A):

What is the amount of surtax to be assessed against Mr. Colvin for the calendar year 1922?

ANSWER:

The surtax on the total net income of $453,600, if computed

under Sec. 211 (a) (2), would be $197,760. The portion of this amount attributable to the sale of the mine would be $\frac{450,000,}{453,600}$ or $196,190.48. The statute provides, however, that the portion attributable to the sale of the mine shall, in 1922, not exceed 16% of the selling price of the mine. The selling price in this case was $600,000, 16% of which is $96,000. The result first arrived at above must therefore be reduced on this account by the excess of $196,190.48 over $96,000, a reduction of $100,190.48, leaving a balance of $97,569.52, which is the total surtax.

REFERENCE:

Sec. 211 (b) (Quoted under Problem 58)

QUESTION (B):

Assume that the mine purchased by Mr. Colvin was acquired by him to be held for investment. Would Mr. Colvin under the circumstances be permitted to avail himself of the option of computing his taxes under section 206 as in the case of "capital net gain?"

ANSWER:

As the mine was not held by Mr. Colvin for more than two years, it is not regarded as a "capital asset" as defined in paragraph (b) of section 206 (quoted under Problem 58).

PROBLEM 58

Illustrating Limitations of Tax in Sale of Mine in 1922, the Principal Value Thereof Being Demonstrated by Prospecting or Exploration and Discovery Work Done by the Taxpayer—Computation Under Provisions Relating to Capital Gain Resulting in Tax Lower than if Computation is made under Provisions Relating to Sale of Mine

FACTS:

James W. Allen, a citizen of the United States, sells a mine in 1922 for $1,000,000, which in 1910 had cost him $200,000. The March 1, 1913, value of the mine was $250,000, but subsequent discoveries by Mr. Allen proved the mine to be worth the amount for which it was later sold. The mine had never been operated and consequently no depletion had been sustained. The cost of effecting and closing the sale was $20,000, leaving a capital net gain of $730,000. In addition to this $730,000, Mr. Allen had ordinary net income of $50,000. He files his return for the calendar year 1922. His exemption is $2,400.

PROBLEM:

Compute the tax for 1922.

SOLUTION:

The computation of the tax under sections 210 and 211 is as follows:

	Capital net gain	$730,000
	Ordinary net income	50,000
	Total (subject to surtax)	$780,000
	Exemption	2,400
	Balance (subject to normal tax)	$777,600
$ 4,000	at 4%	$ 160
773,600	at 8%	61,888
$777,600	Total normal tax	$ 62,048
	Surtax on $780,000 is	$360,960

Portion of surtax attributable to the sale of the mine is $\frac{780,000}{730,000,}$ of $360,960, or $337,821.54. This is $177,821.54 more

than 16% of the selling price of the mine, so that a reduction of that amount is to be made by reason of the limitation set forth in Sec. 211 (b), leaving a surtax of $183,138.46. This amount plus the $62,048 normal tax, results in a total tax of $245,186.46.

The computation under Sec. 206 would result as follows:

Ordinary net income		$50,000
Exemption		2,400
Balance		$47,600
	Income tax	
$ 4,000 at 4%	$ 160	
43,600 at 8%	3,488	
$47,600	$3,648	
Surtax on $50,000	$ 4,960	
12½% of capital net gain	$730,000	$91,250
Income tax, above		3,648
Surtax, above		4,960
Total		$99,858

This amount, $99,858, being less than the total tax of $245,186.46 arrived at by the computation under Sec. 211 (b) will represent Mr. Allen's tax liability, provided, however, that this is not less than 12½% of the total net income. The total net income was $780,000, 12½% of which is $97,500. Mr. Allen's tax liability for 1922 is therefore $99,858.

References:

Sec. 206 (b): "In the case of any taxpayer (other than a corporation) who for any year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in

lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

"A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½% per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income."

Sec. 211 (b): "In case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum, of the selling price of such property or interest."

NOTE:

Section 210 imposes the tax at the normal rates, and section 211 imposes the tax at the graduated surtax rates.

PROBLEM 59

Illustrating Basis of Computation of Net Income

FACTS:

(a) John Weber, whose accounts clearly reflect his income, closes his books annually on June 30th.

(b) George Vernon, whose accounts also reflect his income accurately, closes his books annually on December 31st.

(c) Charles Hall has no annual accounting period and does not keep books.

QUESTION:

How should the above individuals compute net income for income-tax purposes for the taxable year 1921?

ANSWERS:

(a) John Weber should report income on an annual basis beginning July 1, 1920, and ending June 30, 1921, in accordance with the method of accounting regularly employed by him.

(b) George Vernon should report his income on the calendar-

year basis in accordance with the method of accounting regularly employed by him.

(c) Charles Hall must use a method which clearly reflects the true net income and report on the calendar-year basis.

REFERENCES:

Sec. 212 (b): "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year."

Art. 22. Regulations 62: "Net income must be computed with respect to a fixed period. Usually that period is twelve months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. See article 51. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

Art. 23. Regulations 62: "(1) Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 200 of the statute for definitions of "paid," "paid or accrued," and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. See section 213 (a). For instance, in any case in which it is necessary to use an inventory, no accounting in regard to purchases and sales will correctly reflect income except an accrual

method. A taxpayer is deemed to have received items of gross income which have been credited to or set apart for him without restriction. See article 53. On the other hand, appreciation in value of property is not even an accrual of income to a taxpayer prior to the realization of such appreciation through sale or conversion of the property. . . ."

PROBLEM 60

Illustrating Basis for Filing Returns in Case Accounting Period is Changed

FACTS:

(a) Sam Bolden changed the date for the annual closing of his accounts from June 30 to December 31. His last return was filed for the fiscal year ended June 30, 1921.

(b) Edward White changed his yearly closing date from December 31 to September 30. His last return was filed for the calendar year 1921.

(c) Sam Hold changed his yearly closing date from June 30 to September 30. His last return was filed for the fiscal year ended June 30, 1921.

In each case the change in accounting periods was made with the approval of the Commissioner.

QUESTION:

What returns are required to be filed by each of the individuals above mentioned?

ANSWER:

(a) Sam Bolden should file a return for the period from July 1, 1921, to December 31, 1921, inclusive. Thereafter, unless he receives permission from the Commissioner to change, he is required to file returns on the calendar-year basis.

(b) Edward White should file a return for the period from January 1, 1922, to September 30, 1922, inclusive. Thereafter, unless he receives permission from the Commissioner to change, he is required to file returns on the basis of the fiscal year ended September 30.

(c) Sam Hold should file a return for the period from July 1, 1921, to September 30, 1921, inclusive. Thereafter, unless he receives permission from the Commissioner to change, he is required to file returns on the basis of the fiscal year ended September 30.

REFERENCES:

Sec. 212 (c): "If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226."

Sec. 226 (a): "That if a taxpayer, with the approval of the Commissioner, changes the basis of computing net income from fiscal year to calendar year a separate return shall be made for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year."

(b): "In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included."

PROBLEM 61

Illustrating Gross Income—Profits from Business, Compensation for Service, Interest, and Dividends Received

FACTS:

The Profit and Loss Statement of Walter Elsrode for the taxable year ended December 31, 1921 showed the following:

(a) Trading account

Gross sales	$84,000
Less: Returned sales	2,000
	$82,000

Purchases	$60,000		
Less: Returned purchases	6,000	54,000	
		$28,000	
Closing inventory	$43,000		
Opening inventory	24,000	19,000	$47,000
(b) Director's fees			600
(c) Interest on certificate of deposit			3,500
(d) Interest on bonds of domestic corporations			750
(e) Cash dividend on stock of domestic corporation (paid from earnings accrued since Feb. 28, 1913, and not a liquidating dividend.)			750

QUESTION:

Which of the above items are taxable and which, if any, are non-taxable?

ANSWER:

(a) Trading account, $47,000. Taxable.

(b) Director's fees, $600. Taxable.

(c) Interest received on certificates of deposit, $3,500. Taxable.

(d) Interest received on domestic corporation bonds, $750. Taxable.

(e) Cash dividend, domestic corporation stock, $750. Taxable at surtax rates, but not subject to normal taxes.

REFERENCE:

Sec. 213: ". . . the term 'gross income'—

"(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever

form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ."

NOTE:

While the above problem as prepared relates to individuals, such items as are applicable to corporations would be similarly treated if received by corporations.

PROBLEM 62

Illustrating Gross Income—Profit on Sale of Residence Whole of Which has been Continuously Occupied by Owner

FACTS:

Robert P. Ramsey in 1921, sold his residence for $13,000. He had purchased the property in 1916 for $10,000. Depreciation for the 5 years was estimated to be $1,000, which depreciation, however, was not deductible on Mr. Ramsey's income-tax returns.

QUESTION:

What is the amount of profit to be reported by Mr. Ramsey?

ANSWER:

The depreciation, since it could not be deducted as it accrued, need not be taken into consideration in computing the profit from the sale, and the amount to be reported is $13,000 less $10,000, or $3,000.

REFERENCES:

Sec. 213 (a): (Quoted under Problem 61.)

Bul. 30-20-1085; O. D. 600: "Inasmuch as no deduction for depreciation of the personal residence of a taxpayer is allowable in his income tax returns, a taxpayer in determining the gain or loss arising from the sale of his personal residence, continuously occupied by him as such, is not required to reduce the cost of the property or its

fair market value as at March 1, 1913, by the depreciation sustained."

See Problem 63.

PROBLEM 63

Illustrating Gross Income—Profit on Sale of Residence a Part of Which has been Returning Rent.

FACTS:

George H. Hutchins in 1921, sold his residence for $20,000. He had purchased the property in 1916, for $10,000, and had occupied it continuously. Two rooms had, however, been rented out and the income therefrom reported on Mr. Hutchins' tax returns. As an offset against this income Mr. Hutchins had deducted a total of $200 depreciation on his returns.

QUESTION:

What, if any, is the amount of profit to be returned by Mr. Hutchins on the sale of his residence?

ANSWER:

$10,200. The cost less the depreciation deducted is $9,800. This amount deducted from the selling price results in a taxable profit of $10,200.

REFERENCES:

Sec. 213 (a): (Quoted under Problem 61.)

See also Problem 62.

PROBLEM 64

Illustrating Gross Income—Pension Received by a Retired Employee of a State

FACTS:

C. M. Wagner is a retired employee of the State of X, and receives an annual pension of Y dollars from the State.

QUESTION:

Is the amount of this pension to be included in the income of Mr. Wagner subject to the Federal income tax?

ANSWER:

No.

REFERENCES:

Sec. 213 (a) (Quoted under Problem 61)

Bul. 14–20–826; O. D. 434: "Pensions received from a State or a political subdivision thereof by its retired employees are exempt from tax."

Art. 71, Regulations 62: "Gross income excludes the items of income specifically exempted by the statute and also certain other kinds of income by statute or fundamental law free from tax."

31 Opinion Attorney General, 441 (rendered by A. Mitchell Palmer, May 6, 1919.) The substance of this opinion was that the Federal Government was constitutionally unable to tax the wages and salaries of the employees and officers of a State, and that the Act of 1918 was not to be construed to include in taxable income such wages and salaries. That portion of section 213 (a) of the 1918 Act which pertains to salaries received is repeated verbatim in the 1921 Act.

PROBLEM 65

Illustrating Gross Income—Jury Fees

FACTS:

J. J. Jones in 1921, received an amount of Y dollars covering fees and compensation for serving on the jury of a municipal court.

QUESTION:

Is this amount subject to the Federal income tax?

ANSWER:

No.

REFERENCES:

Sec. 213 (a) (Quoted under Problem 61)

Bul. 14–20–826; O. D. 434: "Persons serving on the jury of a State, county, or municipal court are held to be employees of a State

or a political subdivision thereof, and fees and compensation received by them are accordingly exempt from tax."

See also references under Problem 64.

PROBLEM 66

Illustrating Gross Income—Refunded Federal Income Tax

FACTS:

G. O. Gordon receives in 1921, a refund of $60, Federal income tax paid in 1917.

QUESTION:

Is this refund to be reported by Mr. Gordon in his Federal income tax returns as taxable income?

ANSWER:

This would probably not be taxable. This amount was not deductible when paid, and would therefore seem not to be taxable when repaid.

REFERENCES:

Bul. 13–19–418; O. D. 240: "Income taxes assessed under the . . . Revenue Act of 1916 are deductible only if paid prior to January 1, 1917."

See Sec. 214 (a) (3) (Quoted under Problem 101)

NOTE:

While the above problem as prepared relates to an individual the same answer would apply in the case of a corporation.

PROBLEM 67

Illustrating Gross Income—Amount Received as Beneficiary of a Life Insurance Policy

FACTS:

Mr. H. Adams in 1921, received as a beneficiary of a deceased friend's life insurance policy, $10,000.

QUESTION:

Is this amount to be reported as taxable income?

ANSWER:

No.

REFERENCE:

Sec. 213: " . . . the term 'gross income' . . . (b) does not include . . . (1) the proceeds of life insurance policies paid upon the death of the insured."

PROBLEM 68

Illustrating Gross Income—Proceeds of Surrendered Life Insurance Policy

FACTS:

Andrew Allen in 1921, surrendered his life insurance policy taken out in 1901, receiving therefor $2,850. Of this amount $2,800 represented premiums repaid, and $50 represented interest. The cash surrender value of the policy March 1, 1913 was $2,200.

QUESTION:

What part, if any, of the $2,850, is to be included in gross income subject to Federal income taxes?

ANSWER:

The $50 is taxable; the $2,800 is non-taxable.

REFERENCES:

Sec. 213 (a): (Quoted under Problem 61.)

Sec. 213: ". . . The term 'gross income' . . . (b) does not include . . . (2) the amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract; . . ."

Bul. 4–20–701; O. D. 379: "The basis for ascertaining the taxable income resulting from the disposition of a life insurance policy acquired prior to March 1, 1913, where the insured transfers the policy to some one other than the insurance company which wrote the

policy, is the cash surrender value of the policy as at March 1, 1913. However, if the insured surrenders his policy and all his rights thereunder to the insurance company, which wrote the policy, the aggregate amount of the premiums paid during the period the policy was held, or the cash surrender value of the policy as at March 1, 1913, whichever is greater in amount, is to be taken as the basis in computing the taxable income derived by the insured."

PROBLEM 69

Illustrating Gross Income—Legacy Received by Taxpayer with Interest on Same

FACTS:

J. E. Jordon in December, 1921, received as legatee under the will of a relative who had died in March, 1921, $10,300. Of this amount $10,000 was the amount of the legacy itself, and the $300 represented interest accrued from March to December.

QUESTION:

What part, if any, of the $10,300 is to be reported as taxable income?

ANSWER:

The $300.00 is taxable but the $10,000 is non-taxable.

REFERENCE:

Sec. 213: ". . . The term 'gross income' . . . (b) does not include . . . (3) . . . (3) the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income)."

PROBLEM 70

Illustrating Gross Income—Income from Municipal Bonds

FACTS:

J. E. Joseph in 1922, received $4,500 interest on 4½% bonds of the City of New York.

QUESTION:

Is this amount to be reported in Mr. Joseph's income subject to Federal taxes?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . The term 'gross income' . . . (b) does not include . . . (4) interest upon (a) the obligations of a State, Territory or any political subdivision thereof, or the District of Columbia; . . ."

NOTE:

This exemption applies to corporations as well as to individuals.

PROBLEM 71

Illustrating Gross Income—Interest Received on Federal Farm Loan Bonds

FACTS:

John Jarmuth in 1921, received $600 interest on Federal Farm Loan Bonds.

QUESTION:

Is this interest subject to the Federal income taxes?

ANSWER:

No.

REFERENCES:

Sec. 213: ". . . The term 'gross income' . . . (b) does not include . . . (4) Interest upon . . . (b) securities issued under the provisions of the Federal Farm Loan Act of July 17, 1916 . . ."

Art. 75; Regulations 62: ". . . The Federal Farm Loan Act of July 17, 1916, provides that . . . farm loan bonds, with the income therefrom, shall be exempt from taxation."

NOTE:

This exemption applies to corporations the same as to individuals.

PROBLEM 72

Illustrating Gross Income—Interest Received on Liberty Bonds, Victory Notes, and Bonds of the War Finance Corporation

FACTS:

John Jones in 1921, receives interest on the following Government securities, which constitute his entire holdings:

Par value	Security	Interest
$1,000	1st Liberty Bond	$35.00
1,000	2nd " "	40.00
1,000	3rd " "	42.50
1,000	4th " "	42.50
1,000	Victory Note (3¾%)	37.50
1,000	" " (4½%)	47.50
		$245.00

QUESTION:

What part, if any, of the $245 interest received is subject to the income tax, and what part is subject to surtax?

ANSWER:

None of it is subject to income tax. Only the $47.50 interest on the 4¾% Victory Note is subject to surtax. Taxable interest on Liberty bonds should be included in gross income, but is a credit against net income for the normal or income tax.

REFERENCES:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (4) Interest upon . . . (c) the obligations of the United States or its possessions; or (d) bonds issued by the War Finance Corporation. In the case of obligations of the United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is

wholly exempt to the taxpayer from income, war-profits and excess-profits taxes. . . ."

Sec. 1328: "That the various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows:

"(a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows:

"Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

"(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act."

Section 1. [Act of April 24, 1917 (40 Stat., 35)]. (First Liberty Bond Act.)

"The bonds herein authorized shall be in such form and subject to such terms and conditions of issue, conversion, redemption, maturities, payment, and rate and time of payment of interest, not exceeding three and one-half per centum per annum, as the Secretary of the Treasury may prescribe. The principal and interest thereof shall be payable in United States gold coin of the present standard of value and shall be exempt, both as to principal and interest, from all taxation, except estate or inheritance taxes, imposed by authority of the United States, or its possessions, or by any State or local taxing authority; but such bonds shall not bear the circulation privilege."

Section 7. [Act of Sept. 24, 1917 (40 Stat., 288)]. (Second Liberty Bond Act.)

"That none of the bonds authorized by section one, nor of the certificates authorized by section five, or by section six, of this Act, shall bear the circulation privilege. All such bonds and certificates shall be exempt, both as to principal and interest from all taxation now or hereafter imposed by the United States, any State, or any of the United States, or by any local taxing authority, except (a) estate or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the in-

come or profits of individuals, partnerships, associations, or corporations. The interest on an amount of such bonds and certificates the principal of which does not exceed in the aggregate $5,000 owned by any individual, partnership, association, or corporation, shall be exempt from the taxes provided for in subdivision (b) of this section."

Section 1. [Act of Sept. 24, 1918, (40 Stat., 965)]. (Supplement to the Second Liberty Bond Act.)

"That until the expiration of two years after the date of the termination of the war between the United States and the Imperial German Government, as fixed by proclamation of the President . . . (3) The interest on an amount of bonds, the principal of which does not exceed $30,000, owned by any individual, partnership, association or corporation, issued upon conversion of 3½ per centum bonds of the first Liberty Loan in the exercise of any privilege arising as a consequence of the issue of bonds of the fourth Liberty Loan, shall be exempt from such taxes."

NOTE:

The proclamation by the President of the United States dated Nov. 14, 1921 fixed the date of the termination of the war against the German Government as July 2, 1921.

The following schedule is appended to show in condensed form the exemptions that apply in the cases both of corporations and individuals. The exemptions here shown refer to the principal sums, the income from which is exempt from surtaxes (in case of individuals), and excess-profits and war-profits taxes (in case of corporations) only; the securities are all fully exempt from normal or income tax.

3½% Liberty Bonds and 3¾% Victory Notes—entirely exempt for life of obligation.

Exemptions to July 2, 1923

4% and 4¼% Liberty Bonds, original or converted, Treasury Certificates of Indebtedness and Savings Certificates....	$ 5,000	Life of obligation
1st—2nd converted 4¼% Liberty Bonds (issue of October 24, 1918 only)	30,000	July 2, 1923
4% and 4¼% Liberty Bonds, all issues...	125,000	July 2, 1923

Maximum exemption to July 2, 1923 . . . . $160,000

Exemptions July 2, 1923 to July 2, 1926

4% and 4¼% Liberty Bonds, original or converted, Certificates of Indebtedness and Savings Certificates (as above)	$ 5,000	Life of obligation.
4% and 4¼% Liberty Bonds—all issues.	50,000	July 2, 1923 to July 2, 1926
Maximum exemption July 2, 1923 to July 2, 1926	$55,000	

It will be noted that no such qualifications as to original subscriptions to bonds still held at the time of filing the return, as in the case of the 1918 Act, are to be found in the 1921 Act.

There is no exemption in the case of 4¾% Victory Notes.

Bonds of the War Finance Corporation are exempt from normal tax and have a principal exemption of $5,000 (for the life of the obligation) from surtaxes, excess-profits and war-profits taxes.

Sec. 16 [Act of April 5, 1918 (40 Stat., 506)]: "That any and all bonds issued by the Corporation shall be exempt, both as to principal and interest, from all taxation now or hereafter imposed by the United States, any State, or any of the possessions of the United States, or by any local taxing authority, except (a) estate or inheritance taxes, and (b) graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States, upon the income or profits of individuals, partnerships, corporations, or associations. The interest on an amount of such bonds the principal of which does not exceed in the aggregate $5,000 owned by any individual partnership corporation, or association, shall be exempt from the taxes referred to in clause (b) . . . ."

Corporations

The same Liberty Bond, Victory Note and War Finance Bond exemptions apply to corporations as to individuals. See Sec. 233 for law reference.

PROBLEM 73

Illustrating Gross Income—Income of Foreign Governments

FACTS:

A certain foreign government has investments in stocks and bonds in the United States from which it receives income; it also has deposits of government funds in banks in the United States from which it receives interest.

QUESTION:

Are the various items of income of this foreign government above mentioned to be reported for United States Federal tax purposes?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (5) the income of foreign governments received from investments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States; . . ."

PROBLEM 74

Illustrating Gross Income—Health Insurance Received

FACTS:

G. G. Green in 1921 on account of sickness received $500, health insurance.

QUESTION:

Is this amount subject to Federal income tax?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . . the term 'gross income' . . . (b) does not in-

clude . . . (6) amounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness; . . ."

PROBLEM 75

Illustrating Gross Income—Public Utility Income Accruing to a Political Subdivision

FACTS:

The City of Waterbrook, in 1921, derived a net income of $50,000 from the operation of its street-car system.

QUESTION:

Is the above amount to be reported for Federal income tax purposes?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (7) Income derived from any public utility or the exercise of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to the Government of any possession of the United States, or any political subdivision thereof.

"Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract; . . ."

PROBLEM 76

Illustrating Gross Income—Income from Ships Documented Under Laws of a Foreign Country

FACTS:

A. Lienskiviet, a nonresident alien, derives his income from the operation of ships documented under the laws of a certain foreign country. This particular foreign country exempts from income taxes the income of citizens of the United States, or of corporations organized in the United States, derived from the operation of ships documented under the laws of the United States.

QUESTION:

Is the income of A. Lienskiveit to be reported as taxable net income?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (8) The income of a nonresident alien or foreign corporation which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States."

NOTE:

While this problem illustrates the case of a nonresident alien individual the rule enunciated applies with equal propriety to foreign corporations.

PROBLEM 77

Illustrating Gross Income—War Pension and Bonus

FACTS:

S. S. Stone receives in 1921 disability insurance of $960 under

the War Risk Insurance Act and a State bonus of $60 for military service.

QUESTION:

Are these amounts subject to the Federal income tax?

ANSWER:

No.

REFERENCES:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (9) Amounts received as compensation, family allotments and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war. . . ."

Bul. 22-19-533; O. D. 286: "A bonus paid by a State to its residents who served in the military or naval forces during the war with Germany does not constitute taxable income to the recipient."

PROBLEM 78

Illustrating Gross Income—Interest Received From Domestic Building and Loan Association

FACTS:

S. Smith in 1922 received interest amounting to $700, from a domestic building and loan association which was operated exclusively for the purpose of making loans to its members.

QUESTION:

Is the above interest to be returned by Mr. Smith for income tax purposes?

ANSWER:

Only $400 of the $700 received is subject to tax.

REFERENCE:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (10) So much of the amount received by an individual after December 31, 1921, and before January 1, 1927, as dividends or in-

terest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300."

PROBLEM 79

Illustrating Gross Income—Use of Dwelling House Furnished to Minister of Gospel as Part of His Compensation

FACTS:

The Reverend Paul H. Wilson, a minister of the gospel, received in 1921 a stipulated salary of $12,000, and in addition was furnished, as part of his compensation, a dwelling house and garage. The rental value of the house was $3,000 per year, and the rental value of the garage was $240 per year.

QUESTION:

Is the rental value of the house and of the garage to be returned as taxable net income?

ANSWER:

No.

REFERENCE:

Sec. 213: ". . . the term 'gross income' . . . (b) does not include . . . (11) The rental value of a dwelling house and appurtenances thereof furnished to a minister of the gospel as part of his compensation."

PROBLEM 80

Illustrating Gross Income—Receipts of Shipowners' Mutual Protection and Indemnity Association

FACTS:

The Hoboken Shipowners' Protective Association in the calendar year 1921 had receipts (not including income from interest, dividends, and rents) amounting to $200,000, composed exclusively of assessments, the association having been

organized not for profit to itself or any of its members but for mutual protection to all its members.

QUESTION:

Is the above amount to be included in gross income for Federal tax purposes?

ANSWER:

No; the full amount is exempt.

REFERENCE:

Sec. 213: "That for the purposes of this title . . . the term 'gross income' . . . (b) Does not include the following items, which shall be exempt from taxation under this title: . . . (12) The receipts of shipowners' mutual protection and indemnity associations, not organized for profit, and no part of the net earnings of which inures to the benefit of any private stockholder or member, but such corporation shall be subject as other persons to the tax upon their net incomes from interest, dividends, and rents."

PROBLEM 81

Illustrating Gross Income of Nonresident Alien Individual

FACTS:

Jens Pind, a nonresident alien individual, has income from sources within the United States as well as income from his native country and other sources.

QUESTION:

Is Mr. Pind required to include in his gross income reported for U. S. Federal income taxes the full amount received by him from all sources?

ANSWER:

No. He must include only so much of his gross income as is derived from sources within the United States.

REFERENCE:

Sec. 213 (c): "In the case of a nonresident alien individual, gross

income means only the gross income from sources within the United States, determined under the provisions of section 217."

See Problems 159 to 166, inclusive.

PROBLEM 82

Illustrating Deductions Allowed Individuals—Repairs to Leased Property

FACTS:

Henry Fox, a wholesale furrier, leased a loft for a period of five years. The lease provided that the property was to be returned at the end of the lease in the same condition it was in at the date of the lease. In order to comply with this provision it was necessary to make certain repairs during the year. Mr. Fox makes his returns on the cash basis.

QUESTION:

How should the expenditure for repairs be treated for tax purposes?

ANSWER:

It is an allowable deduction from gross income for the year in which paid.

REFERENCES:

Sec. 214: "(a) That in computing net income there shall be allowed as deductions: (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, (including . . . rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

In. Bul. 35-21-1794; O. D. 1014, the Bureau ruled that where "by the terms of the lease the lessee is required to return the leased properties to the lessor at the end of the lease in the same condition they were in at the date of the lease, . . . amounts expended to keep the properties in good condition and repair are deductible as business expenses in the returns of the lessee . . for the years in which such amounts are expended."

Art. 103, Regulations 62: "The cost of incidental repairs which neither materially add to the value of the property nor appreciably

prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. . . ."

Corporations: The principle illustrated above will also apply to corporations.

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including . . . rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity; . . ."

PROBLEM 83

Illustrating Deductions From Gross Income—Newspaper Advertising Expenses

FACTS:

Enoch Edwardes, who is engaged in the selling of men's furnishings, in 1921 expended $20,000 in advertising in local papers.

QUESTION:

How are these expenditures to be treated in Mr. Edwardes' income-tax return?

ANSWER:

Advertising expenses are to be treated as an expense for the year in which paid, or, if the taxpayer keeps his books on an accrual basis, in the year in which such expenses become a liability.

REFERENCE:

Bul. 38-21-1829, O. D., 1039:

". . . It is held that the expenses of such advertising campaign are deductible as a business expense only in the return for the year in which such expenses were paid or in the year in which liability therefor accrued, if the books of the company are kept on an accrual basis."

NOTE:

The same rule would apply in case the taxpayer were a corporation instead of an individual.

PROBLEM 84

Illustrating Deductions from Gross Income—Advertising Expense—Outfitting Baseball Team

FACTS:

Fred Yankey is a manufacturer of plumbing supplies whose product is trade-marked "YANKEE." In preparing his return for the calendar year 1921 he finds that certain amounts have been expended by him in outfitting an employee's baseball team, which travels to nearby communities playing other industrial teams of the same caliber, and using the name "YANKEE SUPPLIES." The result of this is that Mr. Yankey's business is given considerable publicity.

QUESTION:

For income-tax purposes, what is the proper treatment of the expenditures above mentioned?

ANSWER:

These expenditures, being in the nature of advertising, are deductible from gross income.

REFERENCE:

Bul. 37-21-1815; O.D., 1030:

"Inasmuch as it appears that the name of the taxpayer is given considerable publicity in the appearance of the taxpayer's baseball team in various parts of the district in which the taxpayer does business and by a report of the games in the newspapers of the vicinity, it is held that the expenses incurred relative to the outfitting and support of the ball team representing the taxpayer are similar to those expended in other methods of advertising and are deductible as business expenses in the income tax returns of the taxpayer. . . ."

NOTE:

The same ruling would apply in case the taxpayer were a corporation instead of an individual.

PROBLEM 85

Illustrating Deductions From Gross Income—Dues Paid to Trade Associations

FACTS:

Frank French, who is engaged in the manufacture and sale of chemical apparatus, in 1921 pays $200 membership dues to a chemical apparatus manufacturers' association organized to promote the business interests of its members.

QUESTION:

How is the above amount to be treated on Mr. French's income-tax return?

ANSWER:

The Bureau has held that dues paid to an association organized to promote the business interests of its members are deductible from gross income.

REFERENCE:

In Bul. 19-20-916, O. D. 496, the Bureau ruled in connection with dues paid to an association "organized for the purpose of promoting in all lawful ways the general business interests of exporters of forest products by the collection and dissemination to its members of information and statistics relating to such export business . . . that membership dues paid by the members of this association represent a consideration for benefits flowing directly to them as an incident of their business and may, therefore, be deducted from gross income."

NOTE:

The same rule would apply in the case of a corporation taxpayer.

PROBLEM 86

Illustrating Deductions From Gross Income—Membership Dues in Chamber of Commerce

FACTS:

Rowland Royce, who is engaged in the automobile business,

expends $50 in 1921, for membership dues in the Chamber of Commerce in the city in which his business is located. The purpose of Mr. Royce's membership in this organization is to advance his business interests.

QUESTION:

May this item be taken as a deduction in Mr. Royce's income-tax return?

ANSWER:

Yes, the dues would be considered a proper deduction from gross income.

REFERENCE:

Bul. 13-20-808; O. D., 421: "Membership fees or dues paid by individuals and corporations to a chamber of commerce or board of trade are deductible from gross income as a business expense provided the membership is employed as a means of advancing the business interests of the individual or corporation."

PROBLEM 87

Illustrating Deductions from Gross Income—Experimental Expenses

FACTS:

Charles Curtis, a taxpayer engaged in the manufacture of engineering supplies, in 1921 expends $40,000 in experimental work.

QUESTION:

How is this item to be treated on Mr. Curtis' tax return?

ANSWER:

The taxpayer has the option of either captalizing the expenditure, if its nature is such as to improve his facilities or product, or deducting it as a current expense. If capitalized it would be the subject of a depreciation allowance if Mr. Curtis' past experience was such as to enable him to estimate the probable period of usefulness.

REFERENCE:

Art. 168, Regulations 62: "A taxpayer who has incurred expenses in his business for . . . work of an experimental nature calculated to result in improvement of his facilities or his product, may at his option deduct such expenses from gross income for the taxable year in which they are incurred or treat such articles as a capital asset to the extent of the amount so expended. In the latter case, if the period of usefulness of any such asset may be estimated from experience with reasonable accuracy, it may be the subject of depreciation allowances spread over such estimated period of usefulness. The facts must be fully shown in the return or prior thereto to the satisfaction of the Commissioner."

NOTE:

The same rule would apply in the case of a corporation.

PROBLEM 88

Illustrating Deductions From Gross Income—Expenses Incurred in Connection with Automobile Used Partly for Business

FACTS:

Henry Holmes in 1921 expends $600 in the operation and upkeep of an automobile used partly for personal convenience, and partly for business purposes.

QUESTION:

Is the above amount deductible in Mr. Holmes' income-tax return?

ANSWER:

The Committee on Appeals and Review has ruled that where a taxpayer uses an automobile as the means of transportation from his residence to his place of business, such expense is personal and not deductible; but where it is necessary to use a personal automobile, at least in part, for purely business purposes, that portion of the upkeep and operating expenses which can be properly allocated to such use constitutes an allowable deduction.

REFERENCE:

Bul. 26-21-1707; A. R. R., 551: ". . . With reference to the taxpayer's claim for a deduction . . . to cover the amount expended by him . . . in the operation of an automobile used by him for business purposes . . . the Committee is of the opinion . . . if it is ascertained that in order to earn his salary . . ." the taxpayer "was responsible for the discharge of certain duties and that the said automobile was owned and used by him in the performance of those duties, that" a deduction ". . . in such an amount as will cover the actual expenses satisfactorily shown to have been incurred in the operation of the automobile for business purposes" should "be allowed as an ordinary and necessary business expense . . ."

A similar ruling was made in Bul. 41-20-1230; A.R.R., 266.

PROBLEM 89

Illustrating Deductions From Gross Income—Payments to Workmen's Compensation Insurance Fund Required by State Law

FACTS:

James Gordon, owning and operating a drain-tile manufacturing establishment, is required by the statute of the State in which his factory is located to make certain payments each year into a workmen's compensation insurance fund, the fund being the property of the State.

QUESTION:

How are these payments to be treated on Mr. Gordon's income-tax return?

ANSWER:

Since the payments are required by the law to be made to an insurance fund of the State, such payments are deductible from gross income. However, had the law permitted or required the employer to maintain a fund with a trust company as a reserve from which payments would be made as compensation for injuries as such occur, the periodical deposits to such a fund would not be deductible, but the actual amounts paid to the employees as compensation when injuries occur would be deductible.

REFERENCE:

Bul. 27-21-1712; O. D., 964: ". . . Where the employer makes the periodical payments to the insurance fund of a State such payments are allowable deductions for the year in which paid or accrued.

"If, however, the employer maintains a fund actually depositing periodically in a trust company an amount to be held in reserve as a special fund for the payment of compensation as injuries occur, the amount thus deposited is not an allowable deduction from gross income, since there is no means of determining how much of this fund will be used for the purpose for which it is held. In such case the actual amount paid during a year to the employes as compensation where injuries occur is a proper deduction for that year whether the amount so paid is greater or less than the deposits made during the period to the fund which is maintained."

NOTE:

The same ruling would apply in case the taxpayer were a corporation.

PROBLEM 90

Illustrating Deductibility of Bonus to Employees

FACTS:

Harris, Peters & Cook, a Wall Street brokerage firm, for many years past followed the practice of paying its employees a fixed compensation together with bonuses at the end of each year, which bonuses were based upon the profits for the year and the relative importance of the several employees in producing these profits. The firm had no written contract with its employees that it would make such bonus payments. They were, nevertheless, made each year in varying amounts and were paid as additional compensation for services actually rendered by the employees. For the year 1921 the employees whose salaries during the year were $2,000 or under received a bonus of 20% of such salary. Employees whose salaries were in excess of $2,000, but less than $5,000, received a bonus of 25% of said salaries. Employees whose salaries were in excess of $5,000, received a bonus of 30% of said salaries. None of these employees had any proprietary interest in the firm. Taking

into consideration the plan of compensation above described, the salaries paid plus the bonuses did not together exceed reasonable compensation for the services rendered.

QUESTION:

Do the bonuses for 1921 represent allowable deductions from gross income?

ANSWER:

Yes.

REFERENCE:

Art. 107, Regulations 62: "Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. . . . Donations made to employees and others, which do not have in them the element of compensation or are in excess of reasonable compensation for services, are considered gratuities and are not deductible from gross income."

PROBLEM 91

Illustrating Deductibility of Salaries—Salaries in Part Payment for Property not Deductible.

FACTS:

Cauldwell & Rogers, a partnership, were engaged in the business of manufacturing furniture in the City of Jamestown, N. Y. In the year 1916 the partnership sold its assets and business to the High-Class Furniture Company. The agreement of sale provided that both Mr. Cauldwell and Mr. Rogers were to enter the employ of the High-Class Furniture Company and continue in the management of the Jamestown works of the old partnership. This agreement also provided that the old partnership was to receive $400,000 for the tangible property and nothing specifically for the intangible property, although the said intangible property had a value at the date of sale of $500,000. The agreement was that Mr. Cauldwell and Mr. Rogers

were to receive, by way of salary, $100,000 each for the years 1917, 1918 and 1919 and that thereafter their salary was to be $15,000 each per annum. The High-Class Furniture Co. in preparing its income tax returns for the years 1917, 1918, and 1919 included as deductions from gross income the salaries of $100,000 each paid to Mr. Cauldwell and Mr. Rogers. An agent of the Bureau of Internal Revenue made an examination of the company's returns early in 1922 and upon reviewing the facts as stated above, came to the conclusion that the salaries paid to Mr. Cauldwell and Mr. Rogers were excessive and should not be allowed as deductions from gross income, and informed the treasurer of the High-Class Furniture Company that he would recommend to the Bureau at Washington that of the salaries thus paid to Messrs. Cauldwell and Rogers the company be allowed as deductions from gross income only $15,000 for Cauldwell and $15,000 for Rogers.

Question:

Will the Revenue Agent's recommendations be sustained by the Bureau of Internal Revenue at Washington, and if so how should Messrs. Cauldwell and Rogers treat the excess of the amounts received by them over the amount allowed to the corporation as a deduction?

Answer:

From the circumstances as stated it would apear that the payments made to Messrs. Cauldwell and Rogers in the form of salaries constituted, in a very large part, payment for the goodwill of their business and that, therefore, the excess of these payments over a reasonable amount for salaries will be disallowed by the Bureau as deductions from gross income. It is quite likely that under the circumstances the Bureau will not allow more than $15,000 each as a reasonable compensation to Cauldwell and Rogers. The Bureau will probably regard the salary paid Cauldwell and Rogers in 1920 and thereafter as more nearly representing reasonable compensation.

From the viewpoint of Cauldwell and Rogers, the excess paid

over the amount allowed to the corporation as a deduction will be regarded as being in payment of the sale of a capital asset and should be so treated by them for income-tax purposes.

REFERENCES:

Art. 105, Regulations 62: ". . . (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. . . . (b) An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business."

Art. 106, Regulations 62: "As to the treatment of amounts ostensibly paid as compensation, but not allowed to be deducted as such, the following rules apply: . . .

"(2) In the case of excessive payments by individuals or partnerships, the amounts disallowed should ordinarily be treated as shares of the profits of a partnership, except that a payment for property should be treated by the individual or partnership as a capital expenditure and by the recipient as part of the purchase price."

PROBLEM 92

Illustrating Deductibility of Salaries—Salaries in the Form of Contingent Compensation

FACTS:

The Indiana Manufacturing Company in the year 1902 engaged the services of Frank P. Whalen as general manager. The contract of employment provided that Mr. Whalen was to receive a fixed salary of $3,000 per annum plus 10% of the yearly profits of the company. Prior to 1917 the company's profits ranged from $25,000 to $150,000 per year, so that Mr. Whalen in this period received yearly compensation ranging from $5,500 to $18,000. As a result, however, of war work performed by the Indiana Mfg. Co. during 1917, 1918 and 1919, the company's profits for these years were $940,000, $2,320,000, and $1,450,000, respectively. As a result Mr. Whalen's additional compensation, based upon the percentage of profits to

which he was entitled, was $94,000, $232,000, and $145,000, for 1917, 1918, and 1919, respectively, which compensation was duly paid and taken as deduction from gross income on the income-tax returns filed by the company for these years.

An Internal Revenue Agent visited the offices of the company in 1921 and upon examination of the returns of the company filed for the years 1917, 1918, and 1919, took the position that the compensation paid Mr. Whalen was in excess of a reasonable salary as provided by the law.

QUESTION:

Are the payments made to Mr. Whalen, as shown above, to be regarded as coming within the scope of section 234 (a) (1) and allowable as a deduction from gross income as "a reasonable allowance for salaries or other compensation for personal services actually rendered?"

ANSWER:

The salaries and other compensation paid Mr. Whalen are not in excess of reasonable compensation under the circumstances. While the additional compensation was of a contingent nature and for the years in question actually worked out at an amount greater than would ordinarily be paid, as such compensation was paid pursuant to a free bargain between the company and Mr. Whalen before the services were rendered, and was not influenced by any consideration other than that of securing at fair and advantageous terms the services of Mr. Whalen, the compensation thus paid him should be allowed as a deduction from gross income for the years in question.

REFERENCE:

Art. 105, Regulations 62: "Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. This test and its practical application may be further stated and illustrated as follows:

". . . . (2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation

invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid."

"(3) In any event the allowance for the compensation paid may not exceed what is reasonable in all the circumstances. It is in general just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises in like circumstances. . . . The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned."

PROBLEM 93

Illustrating Deductions not Allowed Corporation—Salaries paid in Lieu of Dividends

FACTS:

The Farm Products Company, a domestic corporation, had but two officers, and together they owned or controlled all of its stock. In closing their accounts for the year 1921, they divided the entire profits for the year between themselves as compensation.

QUESTION:

Would this division of the profits constitute an allowable deduction by the corporation from its gross income?

ANSWER:

No, except under a very few circumstances, such as where the profits were so small that the compensation was clearly reasonable for the services performed.

REFERENCES:

Sec. 234 (a): "That in computing the net income of a corpora-

tion subject to the tax imposed by section 230 there shall be allowed as deductions: (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered. . . ."

T. D. 2262—Gives the decision of the U. S. Circuit Court of Appeals for the Second Circuit in the case of Jacob & Davies (Inc.) v. Anderson, collector of internal revenue (228 Fed., 505), wherein it was held that "When a company composed of two stockholders divides the profits between them, calling it compensation, the same cannot be deducted as an expense of business. Money paid out under these circumstances is equivalent to dividend and must be treated as income of the corporation."

Art. 105, Regulations 62: ". . . (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few stockholders, practically all of whom draw salaries. If in such a case the salaries are based upon or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries, if in excess of those ordinarily paid for similar services, are not paid wholly for services rendered, but in part as a distribution of earnings upon the stock."

PROBLEM 94

Illustrating Deductions Allowed—Interest on Indebtedness Incurred to Purchase and Carry Securities

FACTS:

James Baker is in business as an individual with an established fiscal year ending November 30th, whose returns are filed on a cash basis. His income is derived mainly from underwriting entire issues of stocks and bonds of corporations, States and political subdivisions thereof, which he disposes of among banks and a large circle of other clients. It is often necessary to place large loans with his bankers to purchase and carry such issues until disposed of. His records are kept on lines which enable him to know his gain or loss on each underwriting. From these records he has prepared a statement as follows, covering all interest paid during his fiscal year ending November 30, 1921, showing the amount paid on indebtedness which was incurred to purchase or carry each issue of stocks or bonds:

$7,961.32	Firebrick Tire Co.	8% preferred stock
1,684.57	County of Tuckahoe	5½% bonds
5,372.98	Ben Joyce Automobile Co.	7% 2-year notes
1,629.66	Gold Star Oil Co.	Common stock
3,927.54	Eagle Light & Power Co.	6% mortgage bonds 1963
5,502.75	City of Halsey	6% bonds

QUESTION:

Are all of the above interest payments deductible?

ANSWER:

Since the interest on the County of Tuckahoe and City of Halsey bonds is tax exempt, the interest shown above as paid to carry these two securities would not be deductible. Interest paid as above on the other four securities would be deductible in full.

REFERENCE:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . ."

CORPORATIONS.

The above illustration would also apply to corporations subject to the tax imposed by section 230.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (2) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title: . . ."

LIFE INSURANCE COMPANIES.

REFERENCES:

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less . . . (8) All in-

terest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; . . ."

INSURANCE COMPANIES (Other than life or mutual).

REFERENCE:

Sec. 247 (a): "That in computing the net income of an insurance company subject to the tax imposed by section 246 [1] there shall be allowed as deductions: . . . (2) All interest as provided in paragraph (2) of subdivision (a) of section 234; . . ." (See above.)

PROBLEM 95

Illustrating Deductions Allowed—Interest Paid to Purchase and Carry Obligations of the United States Issued After September 24, 1917, Where the Interest Therefrom is Wholly Exempt from Tax

FACTS:

George Peterson, paying teller of the Mt. Vernon State Bank, purchased a $1,000 Fourth Liberty Loan Bond from his broker on Nov. 16, 1921, for $946.60, agreeing to pay for it as follows: At least $250 with his order, and the balance in monthly installments of not less than $100, with the privilege of paying off the unpaid balance at any time. His payments in 1921 were as follows:

Nov. 16, 1921	$296.60
Dec. 16, 1921	100.00

On Jan. 16, 1922, he paid off the balance due his brokers on the purchase—$550. The interest charged by the broker for carrying this purchase was $9.25, which was paid Jan. 16, 1922. Mr. Peterson has no other Government securities.

[1] Sec. 246 imposes a tax on all insurance companies other than life or mutual insurance companies.

QUESTION:

Is the interest of $9.25 deductible by Mr. Peterson and if so, in what year?

ANSWER:

No, for although the interest was paid to purchase obligations of the U. S. issued after Sept. 24, 1917, such obligations were not originally subscribed for by Mr. Peterson.

REFERENCE:

Sec. 214 (a) (2). (Quoted under Problem 94.)

NOTE:

The Revenue Act of 1918 permitted a deduction for interest paid or incurred to purchase or carry obligations of the United States issued after Sept. 24, 1917 (which included the second and subsequent issues of Liberty Bonds). However, the 1921 Act does not permit such a deduction except in the case of an original subscription to such issues.

CORPORATIONS.

The law with respect to the deductibility of interest is the same in the case of corporations as it is in the case of individuals.

REFERENCE:

Sec. 234 (a) (2). (Quoted under Problem 94.)

PROBLEM 96

Illustrating Income to be Reported and Deductions from Gross Income Allowed—Assessments for Local Benefits Paid by Tenant—How Treated by Landlord

FACTS:

Harry Powers has leased a residence in one of the suburbs of St. Louis to a tenant for a number of years at a fixed annual rental with the provision that all taxes and assessments are to be paid by the tenant in addition to this stated rental. During

the year 1921 the street on which this residence was located was paved and curbed and an assessment was levied against the property to cover the proper share of the cost. In accordance with his agreement, the tenant paid the assessment.

QUESTION:

How should the assessment thus paid by the tenant be treated on the return of Mr. Powers for 1921?

ANSWER:

As the assessment is paid for the benefit of Mr. Powers it is regarded as income to him. However as the tax is assessed against property because of an improvement which tends to increase the value of such property, it is not an allowable deduction from gross income on the part of the landlord. (See Problem 97 as to treatment by tenant.)

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (3) Taxes paid or accrued within the taxable year except . . . (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. . . ."

Bul. 3-20-689; O. D., 373: "Assessments for local benefits paid by a tenant for his landlord according to agreement are held to be additional rent paid by the tenant, and therefore deductible from his gross income, provided the tenant uses the property for business purposes. The amount so received by the landlord is taxable income to him, but because of its nature is not an allowable deduction from his gross income." (C. B. 2, page 123).

CORPORATIONS.

This principle also applies in the case of corporations. See Sec. 234 (a) (3) (c) and Sec. 247 (a) (3).

PROBLEM 97

Illustrating Deductions Allowed—Taxes as Part of Rental

FACTS:

Henry Katz leased a certain piece of property for ten years, in which he intended to open up a delicatessen store. His

annual rental was to be $1,500, and in addition he was required to pay such taxes, assessments and water rent as might be levied on the property.

QUESTION:

As he did not have title to the property, are such taxes, etc., paid by Mr. Katz deductible from gross income?

ANSWER:

Yes. These payments are in the nature of additional rental required to be made for the continued use of such business property to which Mr. Katz has not taken, and is not taking, title. (See Problem 96 illustrating treatment by lessor of such payments by lessee.)

REFERENCES:

Sec. 214 (a) (1). (Quoted under Problem 82.)

Art. 109, Regulations 62: ". . . Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant. . . ."

Bul. 3-20-689; O. D., 373: (Quoted under Problem 96).

CORPORATIONS.

Corporations that are required by the terms of their lease to pay such taxes as are assessed against such leased property, are also permitted to deduct such taxes as additional rental.

REFERENCE:

Sec. 234 (a) (1). (Quoted under Problem 82.)

PROBLEM 98

Illustrating Deductions Allowed Corporations—Taxes Paid on Shares of Stockholders Without Reimbursement

FACTS:

The Boonville City Bank was required to pay a stock tax for each of its stockholders, which tax was not reimbursed to the bank by the stockholders.

QUESTION:

Is this tax deductible by the bank on its return?

ANSWER:

Yes.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (3) . . . The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member, which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes."

NOTE:

Where a corporation pays the tax as above for the benefit of its stockholders or members without reimbursement from them such tax is not deductible on the returns of such stockholders or members.

REFERENCE:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions . . . (3) Taxes paid or accrued within the taxable year except . . . (d) Taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer."

PROBLEM 99

Illustrating Deductions Allowed Corporations—Taxes Paid Pursuant to Contract to Pay Normal Tax on its Bonds

FACTS:

The bonds of the Wakefield Foundry Company contain the provision that the obligor agrees to pay for its bondholders the Federal income tax to the extent of 2% on the interest paid annually on these bonds.

QUESTION:

Is this tax deductible by the corporation on its return?

ANSWER:

No.

REFERENCE:

Sec. 234 (a) (3): ". . . In the case of obligors specified in subdivision (b) of section 221 no deduction for the payment of the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed, nor shall such tax be included in the gross income of the obligee."

For quotation of section 221 (b) see Problem 176.

PROBLEM 100

Illustrating Deductions Allowed Corporations—Taxes

FACTS:

The M. E. Baily Co., Inc., paid, among others, the following taxes during the year 1921:—

(a) Capital Stock tax (Federal 1920)

(b) N. Y. State Franchise tax

QUESTION:

Are these taxes deductible on the company's return for the calendar year 1921?

ANSWER:

Yes.

REFERENCES:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (3) Taxes paid or accrued within the taxable year except (a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238, and (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed. . ."

PROBLEM 101

Illustrating Deductions Allowed Individuals—Taxes

FACTS:

During the calendar year 1921, Frank Littlejohn, a real estate broker in the City of Buffalo, paid (or there was paid for him in the case of his stock in the First National Bank) the following taxes:—

(1) $ 342.68—City tax on his residence
(2) 2,573.59—City tax on business property
(3) 153.54—Assessment for street paving in front of residence
(4) 16.50—Water tax on residence occupied by him
(5) 255.52—Water tax on business property
(6) 468.73—N. Y. State Income tax (1920)
(7) 3,259.67—Federal Income tax (1920)
(8) 43.36—N. Y. State tax on his stock in 1st National Bank
(9) 394.55—Federal luxury, club dues, etc., taxes
(10) 12.48—Automobile license of N. Y. State.

The residence referred to above was occupied solely by Mr. Littlejohn and his family. The tax on bank stock was not repaid to the bank.

QUESTION:

What is the status of each of the above items for Federal income tax purposes?

ANSWER:

(1) Deductible; (2) Deductible; (3) Not deductible, being a tax against local benefits of a kind tending to increase the value of the property [Sec. 214 (a) (3) (c)]; (4) Not deductible, being considered a personal expense; (5) Deductible; (6) Deductible; (7) not deductible [Sec. 214 (a) (3) (a)]; (8) Not deductible [Sec. 214 (a) (3) (d)]; (9) Deductible; (10) Deductible.

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . .(3) Taxes paid or accrued within the taxable year except (a) income, war-profits and excess-profits taxes, imposed by the authority of the United States, (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, (c) taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and (d) taxes imposed upon the taxpayer upon his interest as shareholder or member of a corporation, which are paid by the corporation without reimbursement from the taxpayer."

Bul. 45-20-1291; O. D., 719: "The so-called water tax paid by property owners . . . is not an assessment levied against the property owner for the privilege of using the water, but is rather in the nature of a rental paid . . . for a certain commodity furnished . . .

"Accordingly a lessor of residential property is entitled to deduct the water rent paid on such property, since in such case the rent is a business expense incident to the lease of the property. Where water rent is paid on residential property by the person occupying it as such, it becomes a personal expense and is not an allowable deduction."

Art. 131, Regulations 62: ". . . Automobile license fees are ordinarily taxes."

Bul. 20-20-936; O. D., 505: ". . . A taxpayer of the State of New York . . . may in rendering his Federal income tax return . . . deduct . . . the tax . . . imposed by the New York State personal income tax law, . . ." (passed May 14, 1919).

Art. 133, Regulations 62: "So-called taxes, more properly assessments, paid for local benefits, such as street, sidewalk, and other like improvements imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied, do not constitute an allowable deduction from gross income. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. . . ."

Bul. 22-19-535; O. D., 287: "An individual may claim as a deduction the amount of war tax paid on facilities furnished by public utilities, which includes tax on railroad and steamship fares, and the war tax paid on admissions and dues. The war excise taxes imposed by section 904 and paid by the purchaser are deductible. . . ."

PROBLEM 102

Illustrating Deductions Allowed—Taxes—Treatment of that Portion of Foreign Income, War-Profits and Excess-Profits Taxes in Excess of the Credit Allowed under Section 222 (a) (5)

FACTS:

Hobart Collins, an American citizen, showed for the calendar year 1921 (his taxable year) gross income amounting to $54,926.47 and deductions (exclusive of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States) amounting to $26,839.50. Mr. Collins paid income taxes during 1921 to the Dominion of Canada amounting to $756.82. Of this amount, under the limitations of Section 222 (a) (5) of the Revenue Act of 1921, Mr. Collins is entitled to take as a credit against his income tax $398.47.

QUESTION:

What is Mr. Collins' taxable net income for 1921?

ANSWER:

Gross income		$54,926.47
Deductions (exclusive of foreign etc., taxes as above)		26,839.50
		$28,086.97
Income taxes paid to Dominion of Canada	$756.82	
Of which amount Mr. Collins is allowed as a credit against his U. S. income tax	398.47	358.35
Taxable net income		$27,728.62

REFERENCE:

Sec. 214 (a) "That in computing net income there shall be allowed as deductions: . . . (3) Taxes paid or accrued within the taxable year except . . . (b) so much of the income, war-profits and excess-profits taxes, imposed by the authority of any foreign country or possession of the United States, as is allowed as a credit under section 222, . . ."

NOTE:

While this problem is illustrative of individuals, the same principle applies in the case of corporations.

REFERENCES:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as deductions: . . . (3) Taxes paid or accrued within the taxable year except . . . (b) so much of the income, war-profits and excess-profits taxes imposed by the authority of any foreign country or possession of the United States as is allowed as a credit under section 238. . . ."

See Problems 180, 181, and 182 for quotation section 222.

See Problems 183, 185 and 186 for quotation section 238.

PROBLEM 103

Illustrating Deductions Allowed—Losses—Incurred in Trade or Business

FACTS:

Fred Uhler, doing business as The Family Laundry Co., owns several delivery auto trucks, one of which, purchased in 1919, was wrecked in a collision during the taxable year 1921, while out delivering laundry. It was not covered by insurance, and the scrap value was found to be $25, the amount received therefor from a junk dealer.

QUESTION:

May the cost, less sustained depreciation and salvage value, be taken as a deduction on the return for the year in which the truck was wrecked?

ANSWER:

Yes, as it was a loss incurred in business which was not compensated for by insurance.

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in trade or business;"

Art. 141, Reg. 62: "Losses sustained during the taxable year and not compensated for by insurance or otherwise are fully deductible . . . if (a) incurred in the taxpayer's trade or business . . . When loss is claimed through the destruction of property by . . . casualty, the amount deductible will be the difference between the cost of the property, less proper adjustment for depreciation, and the salvage value thereof. . . .

Bul. 13-21-1531, O. D., 857: "A loss may be claimed by the owner of a business truck demolished in collision with a pleasure car provided that the truck was in use in connection with the business of the taxpayer at the time of the collision. No deduction may be claimed by the owner of the pleasure car wrecked in the collision."

CORPORATIONS:

Corporations are also permitted deductions for losses arising from destruction of or damage to property similiar to the case illustrated above.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. . . . In case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; . . ."

PROBLEM 104

Illustrating Deductions Allowed—Farm Losses

FACTS:

Charles Du Bois, Vice-President of the American Manufacturing Company owns two farms, one in Florida and one in the northern part of New York State. Neither of these farms has as yet produced profits from its operation. The Florida

farm was purchased three years ago and is operated on a commercial basis. As the land is cleared it is gradually planted in oranges, grapefruit and pecans. The New York farm consists of 400 acres of which 25 are cultivated to supply the superintendent and his assistants with vegetables and for grain to attract game birds for hunting, and the balance consists of woodland in which there are several small lakes and fishing streams. There is a log cabin on this farm, and Mr. Du Bois makes it his headquarters each year for his hunting and fishing trips in the woodland part of the farm.

QUESTION:

Since both farms show a loss, what is the proper treatment of the operating expenses of each for tax purposes?

ANSWER:

As it takes several years for the trees planted on the Florida farm to mature and bear commercially, it is natural that the operating expenses at first will exceed the income. However, as the farm is operated on a commercial basis the operating expenses are deductible, or they may, at the option of the taxpayer, be capitalized each year, until the farm has reached the productive state (see Art. 110, Reg. 62 below). As the New York farm, however, was operated more for recreation or pleasure than on recognized principles of commercial farming, the operating expenses of this farm should be treated as personal expenses and are not deductible.

REFERENCES:

Art. 38, Regulations 62: ". . . As herein used the term 'farm' embraces the farm in the ordinarily accepted sense, and includes stock, dairy, poultry, fruit, and truck farms, also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers. A person cultivating or operating a farm for recreation or pleasure, the result of which is a continual loss from year to year, is not regarded as a farmer. . . ."

Art. 110, Regulations 62: "A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses

all amounts actually expended in the carrying on of the business for farming. . . . Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may be regarded as investments of capital. . . . If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions. . . ."

Art. 145, Regulations 62: "Losses incurred in the operating of farms as business enterprises are deductible from gross income. . . . If an individual owns and operates a farm, in addition to being engaged in another trade, business, or calling, and sustains a loss from such operation of the farm, then the amount of loss sustained may be deducted from gross income received from all sources, provided the farm is not operated for recreation or pleasure."

PROBLEM 105

Illustrating Deductions Allowed—Losses Due to Sales of Securities after Passage of Revenue Act of 1921; Secdrities Immediately Repurchased

FACTS:

On Dec. 8, 1921, Max Emerson sold for $8,325, one hundred shares of U. S. Steel Common Stock which had cost him $13,662.50 in 1917, in order to write off a loss in this stock. He remembered that under the Revenue Act of 1918 he was permitted to deduct such a loss, and in giving the order to his broker to sell this stock, he also requested it immediately repurchased but from a party different from the one to whom the sale was made, to make the transaction one which the Bureau would consider a bona fide sale and in order that therefore a loss based thereon would be deductible from gross income. The repurchase was made with no intention of again immediately disposing of the stock.

QUESTION:

Does the Revenue Act of 1921 permit the deduction of a loss under these circumstances?

ANSWER:

No. Where stock or other securities are sold after the passage of the Revenue Act of 1921 (Nov. 23, 1921), and within thirty days from such sale the taxpayer acquires identical stock or securities, the loss incurred is not deductible, unless the stock or securities so acquired were received by bequest or inheritance.

REFERENCE:

Sec. 214 (a) (5): (Quoted under Problem 106.)

CORPORATIONS:

The above problem also illustrates the application of this principle as it affects corporations, as the same conditions apply in each case.

REFERENCE:

Sec. 234 (a) (4): (Quoted under Problem 106.)

PROBLEM 106

Illustrating Deductions Allowed—Losses—Sale of Securities where Part Repurchased within 30 Days

FACTS:

On Nov. 30, 1921, J. M. Borden sold 1,000 shares of Complex Motor Co., common stock for $7.50 per share which he had purchased in 1914 for $25 per share. He had intended to wait 30 days before he repurchased the stock but a sudden rise in the market made him apprehensive, and on Dec. 15, 1921, he repurchased 500 shares at $11.50 per share which shares he still holds.

QUESTION:

Will this purchase, made within 30 days after the sale of the identical property, have any effect on the allowance of a loss based on the sale; and if so, to what extent?

ANSWER:

Since one-half of the amount of the property sold was repurchased within 30 days, the deductible loss is only one-half of the

actual loss sustained. The computation of the allowable loss in this case is as follows:

1,000 shares purchased in 1914	$25,000
1,000 shares sold Nov. 30, 1921	7,500
Loss on sale	$17,500

$$\frac{\text{No. shares purchased (500)}}{\text{No. shares sold (1,000)}} \times \text{loss (\$17,500)} = \text{proportion of loss disallowed (\$8,750).}$$

Loss on sale, as above	$17,500
Proportion disallowed	8,750
Allowed as deduction......................	$8,750

Reference:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; . . . No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or disposition. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed."

Corporations.

The above problem also illustrates the application of this principle as it affects corporations, as the same conditions apply in each case.

Reference:

Sec. 234: "That in computing the net income of a corporation

subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No deduction shall be allowed for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within 30 days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a transaction made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. . . ."

NOTE:

The Revenue Act of 1921, was passed Nov. 23, 1921, at 3.55 P. M.

PROBLEM 107

Illustrating Deductions Allowed Individuals—Losses—Securities Sold after Passage of Revenue Act of 1921, with Intention of Repurchase after 30 days after Sale; Identical Securities Received by Bequest 15 Days after Sale

FACTS:

On Nov. 29, 1921, in order to take a loss for tax purposes, Mathew Fox sold 100 shares of N. Y., N. H. & H. R. R. Co. common stock which had cost him $8,900 in 1915, for $1,350. It was his intention to repurchase the same number of shares of that stock after thirty days but on Dec. 14, 1921, he received 100 shares of N. Y. N. H. & H. R. R. Co. stock by bequest.

QUESTION:

Will the receipt of this stock by bequest within 30 days after the sale preclude Mr. Fox from claiming the loss of $7,550, on the sale?

ANSWER:

No. Where stock or securities are acquired by bequest or inheritance which are identical with property previously sold, it has no effect on such sale for tax purposes whether or not received within 30 days after such sale.

REFERENCE:

Sec. 214 (a) (5) (Quoted under Problem 106)

PROBLEM 108

Illustrating Deductions Allowed —Losses—Shrinkage in Securities

FACTS:

Richard Ward, an officer of a manufacturing corporation, upon reviewing his income from securities just prior to the end of the year 1921, found that he had received no dividends or interest on the following:—

(1) 100 Shares Two Cities R. R. Co. Common Stock
(2) 100 Shares K. B. Copper Mining Co. Common Stock
(3) $5,000 bonds of the North Star Lumber Co.

The Two Cities R. R. Company met with financial reverses in 1921, which resulted in the liquidation of the company. The bondholders received the entire proceeds of the sale of the company's assets in 1921, and there was nothing left to be distributed in liquidation to the stockholders.

Due to the present low price of copper the K. B. Copper Mining Company temporarily discontinued operations during the year with the result that the stock was quoted on December 31, 1921, at $4\frac{1}{2}$. Mr. Ward had purchased this stock in 1915, at $27\frac{3}{8}$.

The North Star Lumber Company had large lumber concessions in Mexico under a grant providing that if the company did not operate for 5 continuous years the entire property then reverted to the Mexican Government. Due to the turbulent conditions in that country the company ceased operations in 1916, and

has not deemed it wise to try to resume operations since that time. In 1921, therefore, the company being in default, the concession and all improvements thereon were confiscated, rendering the bonds absolutely worthless.

QUESTION:

Will the above conditions respecting the Two Cities R. R. Company and the K. B. Copper Mining Company stocks and the bonds of the North Star Lumber Company be reflected on Mr. Ward's return for 1921?

ANSWER:

(1) Since the stock of the Two Cities R. R. Company became worthless in 1921, the cost, or March 1, 1913, value if this stock was acquired prior to that date, may be taken as a loss on Mr. Ward's return for 1921.

(2) Since this is a loss or shrinkage in the value of securities due to a fluctuation in the market, and would probably be recovered in the future as the market changed, no loss is deductible except on a sale or other disposition.

(3) Worthless bonds are treated as bad debts, and the cost, or March 1, 1913, value if purchased prior thereto (depending on which of the provisions of Sec. 202 applies to the particular case under consideration), may be taken as a deduction from gross income as they become worthless (see Problem 119). In the case covered by this problem, therefore, Mr. Ward would be permitted a deduction from gross income for 1921, for the loss sustained on account of his North Star Lumber Company bonds, the extent of which would be determined under Sec. 202.

REFERENCES:

Art. 144, Regulations 62: "Shrinkage in value of stocks.—A person possessing stock of a corporation can not deduct from gross income any amount claimed as a loss merely on account of shrinkage in value of such stock through fluctuation of the market or otherwise. The loss allowable in such cases is that actually suffered when the stock is disposed of. See, however, article 154. However, if stock of a corporation becomes worthless, its cost or other basis determined under section 202 may be deducted by the owner in the taxable year in which the stock became worthless, provided a satisfactory showing

of its worthlessness be made, as in the case of bad debts. Where banks or other corporations which are subject to supervision by Federal authorities (or by State authorities maintaining substantially equivalent standards) in obedience to the specific orders or general policy of such supervisory officers charge off stock as worthless or write it down to a nominal value, such stock shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed for income tax purposes to be worthless. See article 151. . . ."

Art. 154, Regulations 62: "Where bonds purchased before March 1, 1913, depreciated in value between the date of purchase and that date, and were in a later year ascertained to be worthless and charged off, the owner is entitled to a deduction in that year equal to the value of the bonds on March 1, 1913. Bonds purchased since February 28, 1913, when ascertained to be worthless, may be treated as bad debts to the amount actually paid for them. Bonds of an insolvent corporation secured only by a mortgage from which on foreclosure nothing is realized for the bondholders are regarded as ascertained to be worthless not later than the year of the foreclosure sale, and no deduction for a bad debt is allowable in computing a bondholder's income for a subsequent year. To authorize a deduction for a bad debt on account of notes held prior to March 1, 1913, their value on that date must be established. . . .

"A taxpayer (other than a dealer in securities) possessing debts evidenced by bonds or other similar obligations can not deduct from gross income any amount merely on account of market fluctuation. Where a taxpayer ascertains, however, that due, for instance, to the financial condition of the debtor, or conditions other than market fluctuation, he will recover upon maturity none or only a part of the debt evidenced by the bonds or other similar obligations and is able to so demonstrate to the satisfaction of the Commissioner, he may deduct in computing net income the uncollectible part of the debt evidenced by the bonds or other similar obligations."

CORPORATIONS:

The principles illustrated in the above problem will also apply in the case of corporations.

PROBLEM 109

Illustrating Deductions Allowed Individuals—Loss on Sale of Residential Property

FACTS:

Charles Martin has lived in the old family homestead for about ten years. In 1921 the neighborhood had run down and he

decided to move to a better part of town. He therefore sold his home and the amount realized on the sale was less than the March 1, 1913, value of the house.

QUESTION:

Could the difference between the March 1, 1913, value and the selling price be deducted on his return for 1921?

ANSWER:

No, for the Bureau has held that the acquisition of residential property is not a "transaction entered into for profit" when the taxpayer resides therein, and hence a loss on the sale of such property used as a residence of the taxpayer is not deductible.

REFERENCES:

Sec. 214 (a) (5): (Quoted under Problem 106.)

Art. 141, Reg. 62 (see Treasury Decision 3209): ". . . A loss on the sale of residential property is not deductible unless the property was purchased or constructed by the taxpayer with a view to its subsequent sale for pecuniary profit. . . ."

PROBLEM 110

Illustrating Deductions Allowed Individuals—Losses—Apartment Sublet at Reduced Rental

FACTS:

Richard Brown had leased an apartment in 1920, for his personal use, for a period of five years at an annual rate of $1,800. In January, 1921, his business necessitated his removal to another city. In the meantime rents in that locality had dropped and in subletting the apartment he was unable to get a better price than $1,200.

QUESTION:

May the difference be taken as a loss on his return for the calendar year 1921?

ANSWER:

No, for the Bureau has ruled that a transaction of this nature was not "entered into for profit."

REFERENCES:

Sec. 214 (a) (5) (Quoted under Problem 106)

In Bul. 1-19-59; O. D. 42, the Bureau ruled that: "The subletting of an apartment by a tenant on account of being required to make his residence in another city, is held not to be a 'transaction entered into for profit.' Therefore, any loss sustained through such transaction is not deductible from gross income."

PROBLEM 111

Illustrating Deductions Allowed—Losses Arising from Storms, Etc.

FACTS:

Donald Parker owned a summer home (on which he carried no insurance) on the beach of Ocean Side. During February, 1921, one of the heavy winter storms swept away part of the foundations and made the collapse of the building certain if not removed and repaired. In order to repair the damage the house was moved back 50 feet from the shore.

The cost of repairing the damage was $150, and the cost of moving the house back 50 feet was $75. In June of the same year he decided to move it to a safer location to prevent possible further damage from future storms. The cost of the second removal was $125.

(1) QUESTION:

Is the cost of repairing the damage ($150) deductible?

ANSWER:

Yes.

(2) QUESTION:

Is the cost of the first removal ($75) deductible?

ANSWER:

Yes.

(3) QUESTION:

Is the cost of the second removal in June ($125) deductible?

ANSWER:

No.

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . "(6) Losses sustained during the taxable year of property not connected with the trade or business . . . if arising from storms . . . and if not compensated for by insurance or otherwise . . . in case of losses arising from destruction of or damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913."

Bul. 43-20-1259, O. D. 698: "A taxpayer's personal residence located on a beach was damaged by a storm, which washed away part of the foundation and so undermined the building as to render its destruction certain if it was not immediately removed. In removing the building to a safer location it was further damaged.

"The damage caused by the direct action of the storm and by the removal to avoid further probable damage is held to have arisen from storm and deductible from gross income as a loss within the meaning of section 214 (a) (6) of the Revenue Act of 1918. If the building was moved to prevent further loss from the storm in question, the expense of moving it is also deductible as a loss; but if it was moved to prevent probable losses from future storms, the expense of moving it is regarded as a capital expenditure and should be added to the cost of the building in computing profit in the event of its sale, since the removal to a safer locality presumably increased its value."

CORPORATIONS:

Corporations are also permitted a deduction for losses arising from destruction of or damage to property similar to the case illustrated above.

REFERENCE:

Sec. 234 (a) (4) (Quoted under Problem 103)

PROBLEM 112

Illustrating Deductions Allowed Individuals—Losses in Case of Nonresident Alien—Loss by Fire

FACTS:

Jules Leblanc, a nonresident alien of the United States, owned

several houses in the United States from which he received rental. During 1921, one of these houses not covered by insurance, burned to the ground.

QUESTION:

Since Mr. Leblanc is a nonresident, would his agents in the United States be correct in deducting this loss from his other income from sources within the United States in preparing his return of income?

ANSWER:

Yes, as the property which was destroyed was located in the United States, and Mr. Leblanc was not compensated for the loss by insurance or otherwise.

REFERENCE:

Sec. 214 (a) (6) (Quoted under Problem 111)

PROBLEM 113

Illustrating Deductibility of Loss when Ascertained

FACTS:

For the calendar year 1921, the books of the Installment Furniture Company showed a net income of $25,000. The annual statements were duly prepared on this basis and presented to the board of directors at the annual meeting, and approved. These statements were also used in connection with the negotiation for certain loans. Subsequently to the closing of the books and the preparation of the statements mentioned above, the president of the corporation was led to believe that the accounts of the cashier were not all as they should be. He consequently instituted an investigation in 1922, and found that the cashier had systematically embezzled funds during the year 1921. The total amount taken by the cashier aggregated $40,000. The cashier, it was found, had dissipated every dollar of his ill-gotten gains and was financially irresponsible.

QUESTION:

For what year may the loss or embezzlement be taken as a deduction from gross income?

ANSWER:

The corporation, in the preparation of its return for the year 1921, should show the loss above mentioned as a deduction from gross income. However, if it desires to account for the loss for the year in which it was ascertained, that is, in 1922, the corporation should attach to its return a statement of the facts upon which it relies and the Commissioner, upon due consideration, may permit the loss to be accounted for during the year 1922. The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this discretion only in exceptional cases.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . .

"(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. . . ."

T. D. 3261.—"The losses allowed as deductions under Sections 214 (a) (4), (5), and (6),[1] and 234 (a) (4) [1] of the Revenue Act of 1921 shall be deducted as of the taxable year in which sustained. In exceptional circumstances, however, in order to avoid injustice to the taxpayer and to more clearly reflect his income the Commissioner may permit a loss to be accounted for as of a year other than the one in which sustained. For example, an embezzlement or a shipwreck may occur in 1921 but not become known until 1922 and in such a case income may be more clearly reflected by accounting for the loss as of 1922 rather than of 1921. If a taxpayer desires to account for a loss as of a period other than the one in which actually sustained, he shall attach to his return a statement setting forth his request for consideration of the case by the Commissioner, together with a complete statement of the facts upon which he relies. However, in his income tax return he shall deduct the loss only for the taxable year in which actually sustained. Upon the audit of the return the Commissioner will decide whether the case is within the exception provided by the statute; if not within the exception the loss will be allowed

[1] See qualification under section 2 & 4 (a) (4) quoted above.

only as of the taxable year in which sustained. The allowance of a deduction for a loss in a year other than the one in which sustained is entirely within the discretion of the Commissioner and he will consider exercising this discretion only in exceptional cases. . . ."

PROBLEM 114

Illustrating Losses Due to Shrinkage in Inventory

FACTS:

The Oswego Paper Manufacturing Company filed its returns on the fiscal-year basis ended June 30. In computing its net income for the fiscal year ending June 30, 1921, it followed its customary practice of pricing its closing inventory on the basis of cost or market, whichever was lower. Due to a change in conditions which particularly affected its own business, the value of its inventory as reported at June 30, 1921, considerably declined. In view of the provision of the Revenue Act of 1921, under Paragraph 4, of Subdivision (a) of Section 234 which permits the deduction of—

"Losses sustained during the taxable year and not compensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period."

The corporation desires to file an amended return for the fiscal year ended June 30, 1921, and revise its inventory as of the closing date on the basis of the reduced values which prevailed subsequent thereto.

QUESTION:

Will such a revision in inventory be permitted by the Commissioner?

ANSWER:

No. The inventories having been originally computed on the basis of cost or market, whichever was lower, were computed in accordance with the regulations. The market referred to was the market prevailing at the inventory date. A subsequent de-

cline in the market does not change the results of the previous year, for income tax purposes, and by the express ruling of the Treasury Department, such a decline is not such a loss as is contemplated by the provision of the statute authorizing the Commissioner to allow the deduction of a loss for a taxable year other than the one in which sustained.

REFERENCE:

T. D. 3261: " . . . A shrinkage in the value of the taxpayer's stock in trade, as reflected in his inventory, is not such a loss as is contemplated by the provision of the statute authorizing the Commissioner to allow the deduction of a loss for a taxable year other than the one in which sustained. . . ."

PROBLEM 115

Illustrating Deductibility in the Case of Banks or Other Corporations of Items written down in Accordance with Specific Orders of Federal or Other Authorities

FACTS:

The Dyckman National Bank, organized under the laws of the State of New York, had among its assets on June 30, 1921, stock in certain corporations. Upon an examination of the accounts of the bank by a Federal bank examiner, the bank was instructed by the Federal authorities to write down the stock above mentioned to a nominal value of $100. This resulted in a charge against Profit and Loss for the calendar year 1921, of $249,900. The stock mentioned had been acquired at a cost of $250,000, in the year 1918.

QUESTION:

May the write down of $249,900, be taken as a deduction from gross income by the bank in its return for the calendar year 1921?

ANSWER:

In the absence of affirmative evidence clearly establishing the contrary, the write down under the circumstances such as

described above will be regarded as evidencing the worthlessness of the stock and will constitute an allowable deduction from gross income. In a case such as described above it is presumed that the stock is worthless for income tax purposes.

REFERENCE:

T. D. 3261: " . . . Where banks or other corporations which are subject to supervision by federal authorities (or by state authorities maintaining substantially equivalent standards) in obedience to the specific orders or general policy of such supervisory officers charge off stock as worthless or write it down to a nominal value, such stock shall, in the absence of affirmative evidence clearly establishing the contrary, be presumed for income tax purposes to be worthless. . . ."

PROBLEM 116

Illustrating Deductions Allowed—Loss by Theft Partly Covered by Insurance

FACTS:

Frank Munson had personal property which in 1914 had cost him in the aggregate $800. It was all stolen from him in 1921. The loss was covered by insurance to the extent only of $500.

QUESTION:

Is he entitled to a deduction in his return for the calendar year 1921, on account of this theft, and if so, to what extent?

ANSWER:

A loss from theft is deductible, but the loss must be reduced by the amount of insurance received. His deductible loss, therefore, is $300.

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . .

"(6) Losses sustained during the taxable year of property not connected with the trade or business . . . if arising from . . . theft, and if not compensated for by insurance or otherwise. . . ."

Art. 141, (as amended by T. D. 3209) Reg. 45 Revised: ". . . The

loss should be reduced by the amount of any insurance or other compensation received. . . ."

CORPORATIONS:

Corporations are similarly allowed deductions for losses by theft not covered by insurance.

LAW REFERENCE:

Sec. 234 (a) (4) (Quoted under Problem 103)

PROBLEM 117

Illustrating Deductions Allowed —Loss of Useful Value

FACTS:

The Whitehall Knitting Mills, Inc., was organized in 1914. It had its own central power plant which supplied the power for each of its several buildings located on the outskirts of a New England city. During the year 1921 it was found that power could be purchased from a new hydro-electric power company, whose lines ran past the mills, at a much lower figure than it cost to produce their own power. Accordingly the company scrapped its entire power plant and transmission equipment and installed small individual electric motors for each of its machines.

QUESTION:

In preparing its return for 1921, would the company be justified in deducting as a loss the cost of such power plant and equipment and transmission equipment, less the salvage value and depreciation sustained on these assets?

ANSWER:

Yes.

REFERENCES:

Sec. 234 (a) (4) (Quoted under Problem 103)

Art. 143, Reg. 62: "When through some change in business conditions the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the busi-

ness or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the cost, or, if acquired prior to March 1, 1913, fair market price or value as of that date of any assets so discarded (less any depreciation sustained and allowable as a deduction in computing net income) and its salvage value remaining. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforeseen cause by reason of which the property has been prematurely discarded, as for example, where an increase in the cost of or other change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allowances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be charged off on the books and fully explained in returns of income. But see articles 181–189."

INDIVIDUALS:

Individuals are also permitted a deduction for the loss of useful value of property used in trade or business.

REFERENCES:

Sec. 214 (a) (4) (Quoted under Problem 103)
Art. 143, Regulations 62, (quoted above).

PROBLEM 118

Illustrating Deductions Allowed—Losses—Voluntary Removal of Buildings

FACTS:

At the beginning of 1921, The Continental Silver Company decided to increase the capacity of its plant by erecting a large modern building. In order to provide space for this additional structure it was necessary to demolish an old building on the company's property acquired in 1870, and several old houses on adjoining property which was purchased in February, 1921, for

the purpose of erecting part of the new building on it. By March both sites had been cleared and building operations begun.

QUESTIONS:

(1) May that portion of the cost of the old building which has not been depreciated be written off as a loss?

(2) Is the cost of demolishing the old building deductible?

(3) Is the cost of demolishing the old houses on the newly purchased property on which a part of the new building was to be erected deductible?

(4) Is the cost of the old house deductible as a loss?

ANSWERS:

(1) Yes; the excess of the depreciated value over the salvage value is deductible. (2) Yes. (3) No. (4) No.

REFERENCES:

Sec. 234 (a) (4) (Quoted under Problem 103)

Art. 142, Regulations 62: "Voluntary removal of buildings—Loss due to the voluntary removal or demolition of old buildings, the scrapping of old machinery, equipment, etc. incident to renewals and replacements will be deductible from gross income in a sum representing the difference between the cost of such property demolished or scrapped and the amount of depreciation sustained with respect to the property prior to its demolition or scrapping, and allowable as a deduction in computing net income. When a taxpayer buys real estate upon which is located a building which he proceeds to raze with a view to erecting thereon another building, it will be considered that the taxpayer has sustained no deductible loss by reason of the demolition of the old building, and no deductible expense on account of the cost of such removal, the value of the real estate, exclusive of old improvements, being presumably equal to the purchase price of the land and building plus the cost of removing the useless building."

INDIVIDUALS:

Assume the same facts as above except that the business was that of an individual instead of a corporation.

QUESTION:

Would the individual be allowed the same deductions allowed the corporation in the foregoing problem, and be denied the deductions the corporation was denied?

ANSWER:

Yes, to both questions.

REFERENCE:

Sec. 214 (a) (4) (Quoted under Problem 103)

PROBLEM 119

Illustrating Manner in Which Deductions from Gross Income May Be Taken on Account of Bad Debts

FACTS:

The Leather Goods Specialties Corporation manufactured leather novelties to be used for advertising purposes. Its sales were usually in small amounts and were made on a credit basis to customers throughout the United States. The percentage of gross profit on sales was very large. However, as many of the customers of the company were small tradesmen and to a large extent, new in business, bad debts were rather frequent and heavy. The company in fixing the sales price of its product took into consideration the fact that its percentage of bad debts was large. The records of the company for the last ten years showed that the bad debts per annum ranged from 5% of the gross sales to 10% of the gross sales and that the total bad debts for this period represented 6% of the total gross sales. The company files its return for 1921 on the calendar-year basis. The analysis of its Reserve for Bad Debts Account for the year shows the following:

Jan. 1, 1921, Reserve for Bad Debts, credit balance	$146,000
Credit to Reserve for Bad Debts and charge to profit and loss for 1921, 6% of gross sales for the year	65,000
	$211,000

Charge to Reserve for Bad Debts and credit

to accounts receivable (for details see below)	95,000
Balance	$116,000

An analysis of the accounts written off by a charge against Reserve for Bad Debts shows that $35,000 was written off on account of debts ascertained in 1921 to be wholly worthless and that $60,000 was written off Accounts Receivable on account of debts ascertained in 1921 to be only partly worthless. Of this total of $95,000 ascertained in 1921 to be worthless, $70,000 consisted of debts (or portions of debts) outstanding December 31, 1920.

QUESTION:

What amount may be taken as a deduction from gross income for the year 1921 on account of bad debts?

ANSWER:

The company may compute its deduction from gross income for tax purposes on account of bad debts on either one of the two following bases, namely: (1) on the basis of the debts ascertained to be worthless in whole or in part during 1921, or (2) on the basis of the addition to the Reserve for Bad Debts set up by it in 1921.

Under (1) the deduction in 1921 would be

(a) Debts found to be worthless in whole	$35,000
(b) Debts found to be worthless in part (worthless portion)	60,000
Total	$95,000

Under (2) the deduction in 1921 would be:

Credit to Reserve for Bad Debts in 1921	$65,000

Debts outstanding December 31, 1920, which proved in 1921 to be worthless (including worthless portion of debts proved to be worthless in part)	70,000
Total	$135,000

Whichever method is elected by the taxpayer in 1921, will be required to be continued in later years, unless permission to change to the other method is granted by the Commissioner. If the first method above mentioned is adopted a statement should accompany the return showing the propriety of the deduction claimed.

If the second method is adopted a statement should accompany the return showing the volume of the company's charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year. In connection with the debts charged against the reserve, the statement should show the date on which each of the debts was incurred.

References:

Art. 151 Regulations 62: "Bad debts.—Bad debts may be treated in either of two ways—(1) by a deduction from income in respect of debts ascertained to be worthless in whole or in part, or (2) by a deduction from income of an addition to a reserve for bad debts. For the year 1921 taxpayers may, regardless of their previous practice, elect either of these two methods and will be required to continue the use in later years of the method so elected unless permission to change to the other method is granted by the Commissioner.

"Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall

be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is charged down to a nominal amount, or the loss is determined in some other manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off, and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, in securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

"Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy cases is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year. In the case of debts existing prior to March 1, 1913, only their value on that date may be deducted upon subsequently ascertaining them to be worthless. See article 51. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation."

Art. 155, Regulations 62: "Reserve for bad debts.—Taxpayers who have, prior to 1921, maintained reserve accounts for bad debts may deduct a reasonable addition to such reserves in lieu of a deduction for specific bad-debt items. Taxpayers who have not heretofore maintained such reserve accounts may now elect to do so, and in such case shall proceed to determine the amount of the reserve that should reasonably have been set up as at December 31, 1920 (which shall not be deducted in computing net income), and in respect of 1921 and subsequent years may add a reasonable addition to such reserve and deduct the amount in computing taxable net income. Where a reserve account is maintained, debts ascertained after December 31, 1920, to be worthless in whole or in part, (*a*) if such debts were outstanding at December 31, 1920, should be charged against the

reserve and may be deducted from income, in accordance with article 151; (*b*) if such debts arose after December 31, 1920, should be charged against the reserve, and not deducted from income. What constitutes a reasonable addition to a reserve for bad debts must be determined in the light of the facts, and will vary as between classes of business and with conditions of business prosperity. A taxpayer using the reserve method should make a statement in his return showing the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year."

NOTE:

The Revenue Act of 1921, is the first to recognize a deduction for bad debts on account of anticipated losses through the setting up of a reserve for bad debts. This recognition is in conformity with accounting and business practice.

PROBLEM 120

Illustrating Capital Sum Which Forms Basis for Depreciation Deduction

FACTS:

Frank Van Horsen constructed an office building in 1908, at a cost of $540,000. Its estimated period of usefulness at the end of the time of construction was fifty years. The building was kept in exceptionally good repair and this fact, together with an appreciation in values, enabled Mr. Van Horsen to satisfy the Commissioner that the fair market value of the building on March 1, 1913, was $600,000. Mr. Van Horsen owned this building during the entire calendar year 1921.

QUESTION:

What was the basis for computation of the depreciation suffered during 1921?

ANSWER:

Since the property was acquired prior to March 1, 1913, its value on that date is the capital sum to be depreciated. The

method ordinarily followed by the Bureau of Internal Revenue is to write off the March 1, 1913, value, less the salvage value of the property, in equal annual installments over the period of the useful life of the building from March 1, 1913. The Bureau has refrained from establishing any fixed rates of depreciation. It has taken the position that the facts in each particular case would govern as to the depreciation rates to be used.

Reference:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (8) a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;"

Bureau of Internal Revenue Bulletin "F," page 19:

"When the fair market price or value of property as of March 1, 1913, is used as the basis for computing depreciation deductions, such price or value should be spread ratably over the remaining useful life of the property and deductions made accordingly. Such deductions are allowable until the total equals the fair market price or value of the property as at March 1, 1913, irrespective of amounts deducted prior to that date."

Bureau of Internal Revenue Bulletin "F," pages 30 and 31:

"The proper allowance which may be deducted from gross income for depreciation and obsolescence of property used in the trade or business is an amount which should be set aside by a taxpayer during each year of the useful life of the property according to a consistent plan by which the total of such amounts for the useful life of the property, together with its salvage value at the end of its useful life in the business, will provide in place of the property its cost or its fair market value as of March 1, 1913, if acquired by the taxpayer prior to that date. . . . The capital sum to be replaced by allowances for depreciation should be charged off over the useful life of the property, either in equal annual installments, this plan being generally known as the 'fixed percentage' method, or in accordance with any other recognized trade practice, such as apportionment over units of production." (See Problem 124 for illustration of allowance based on units of production.)

Corporations:

The conditions that apply to individuals with respect to property used in business, apply equally to corporations.

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as

deductions: . . . (7) a reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;"

PROBLEM 121

Illustrating Modification of Method of Computing Depreciation

FACTS:

On July 1, 1918, the Hemstead Chemical Company installed certain apparatus to be used in the manufacture of the company's product. This apparatus represented a new invention, and the company had no past experience on the basis of which accurately to estimate the future life of this apparatus. However, from the best knowledge available at the time of the purchase, the company estimated that the useful life of the apparatus in question would be five years. The cost of the apparatus in question was $100,000. Up to December 31, 1920 the company had written off by way of depreciation on account of this apparatus the sum of $50,000. This depreciation was duly claimed as a deduction from gross income by the company in filing its income tax returns. At the end of 1921, as the result of a survey made by engineers of the company, it was determined that the apparatus had a remaining life of four years, that is, its usefulness would expire at the close of 1925. The company files its returns on the calendar-year basis.

QUESTION:

What is the allowable depreciation on account of the apparatus above mentioned?

ANSWER:

The depreciated balance of the apparatus in question, that is $50,000, should be spread over the estimated remaining life of the property which is five years from the beginning of 1921.

The depreciation allowable therefore for the year 1921 would be 20% of $50,000, or $10,000.

REFERENCE:

Art. 166, Reg. 62: *"Modification of method of computing depreciation.*—If it develops that an error has been made in estimating, the useful life of the property, the plan of computing depreciation should be modified and the balance of the cost of the property, or its fair market value as of March 1, 1913, not already provided for through a depreciation reserve or deducted from book value, should be spread over the estimated remaining life of the property. Inasmuch as under the provisions of the income tax acts in effect prior to the Revenue Act of 1918 deductions for obsolescence of property were not allowed except as a loss for the year in which the property was sold or permanently abandoned, a taxpayer may for 1918 and subsequent years revise the estimate of the useful life of any property so as to allow for such future (not past) obsolescence as may be expected from experience to result from the normal progress of the art. No modification of the method should be made on account of changes in the market value of the property from time to time, such as, on the one hand, loss in rental value of the buildings due to deterioration of the neighborhood, or, on the other, appreciation due to increased demand. The conditions affecting such market values should be taken into consideration only so far as they affect the estimated useful life of the property."

PROBLEM 122

Illustrating Increase in Depreciation Resulting from Unusual Conditions

FACTS:

The Baltimore Machinery Company in the year 1921 was confronted with a strike on the part of certain machinists and helpers. During the period while these employees were out on strike, it obtained the services of "strike breakers." These "strike breakers" were not fully acquainted with the type of machinery used by the company, with the result that they caused an unusual wear and tear to be suffered. The depreciation in prior years had been based upon an estimated life of ten years. The particular machines upon which these "strike breakers" were engaged were purchased at the beginning of 1919, at a cost

of $50,000. The depreciation had been computed for 1919, and 1920, at the rate of $5,000, per annum so that the depreciated balance at the beginning of 1921 was $40,000. It was estimated that on the basis of the usage to which the machinery in question was put, and on a basis of a similar usage in the future, the remaining useful life beyond the close of 1921, would be not more than three years, even though the machinery was kept in good repair. The company intends, under the circumstances, to claim a deduction for depreciation on account of these machines for the calendar year 1921, of $10,000.

QUESTION:

Would such claim be entertained by the Bureau of Internal Revenue?

ANSWER:

Where the "straight-line" method of depreciation has been adopted by the taxpayer, that is, where the capital sum subject to depreciation is written off in equal annual installments, the Bureau expects that this method will be consistently followed. However, it has permitted allowances for depreciation in addition to the amounts which would result from the employment of the straight-line method, where unusual conditions have existed which give rise to extraordinary wear and tear. Consequently, it would appear that as the corporation's claim is based upon actual facts, and as the computation of the depreciation is correctly made in accordance with those facts, the claim should be allowed. The computation of the depreciation for 1921 is as follows: The depreciation rate of 25% (based upon a four-year life under the conditions existing in 1921) is applied to the depreciated balance of the property at January 1, 1921, viz., $40,000, resulting in a depreciation of $10,000.

REFERENCE:

Cf. Bul. 16-20-862; A. R. R. 45: "When delicate machinery designed for the manufacture of a certain product is used in manufacturing a product of much coarser materials for which use it is not fitted, and is operated at a heavy overload of its normal capacity, the owner is entitled to deduct from gross income an amount representing extraordinary depreciation."

PROBLEM 123

Illustrating Deductions Allowed Individuals—Depreciation of Property used in Professions

FACTS:

Dr. F. W. Scott, a specialist in diseases of the throat, opened an office in Pittsburg February 1, 1921. He installed in that office his medical library, office furniture and the necessary equipment for the practice of his profession. In addition to this office, he used three rooms in his residence of 8 rooms, for an office, beginning Feb. 1, 1921, which was also properly equipped. In June, 1921, his practice grew to such an extent that it became necessary for him to purchase an automobile which he used partly in connection with his practice. The residence was purchased in 1920. His return is made on a calendar year basis.

QUESTION:

What amount would he be entitled to take as a deduction on account of depreciation?

ANSWER:

In Bulletin "F," the Bureau has held that it is "considered impracticable to prescribe fixed definite rates of depreciation which would be allowable for all property of a given class or character. The rate at which property depreciates necessarily depends upon its character, locality, purpose for which used, and the conditions under which it is used." Under these circumstances each taxpayer should determine as accurately as possible according to his judgment and experience the rate at which his property depreciates.

There would be an allowance for depreciation on each class of property referred to in the given facts above. As his return is made on a calendar year basis, the allowance for 1921, covering his office furniture, equipment and library would be $^{11}/_{12}$ of the annual allowance. In the case of his residence office

the annual allowance for that portion used as an office (three rooms out of eight) would be $3/8$ of the cost of the house (since it was purchased after March 1, 1913) divided by the number of years of expected utility. For 1921, the allowance would be $11/12$ of this annual allowance. The 1921 allowance covering the equipment of these three rooms used as an office would be $11/12$ of the annual allowance. In the case of his automobile purchased in June, if it were used solely for business purposes, the 1921 allowance would be $7/12$ of the annual allowance. As however, it was used only in part for business purposes, that allowance must be still further reduced depending upon the relative use in business compared with total use.

REFERENCE:

Sec. 214 (a) (8): (Quoted under Problem 120.)

Bul. "F" Page 6, "Automobiles.—A deduction may be claimed for depreciation of automobiles and similar equipment used in the trade or business. The rate will depend principally on the purpose for which the equipment is used and must be estimated in each case by the taxpayer according to his experience and judgment. A professional man who uses an automobile in making professional calls is entitled to an allowance for depreciation, but if the automobile is used partly for pleasure or purposes apart from the business only a proportionate part of the depreciation sustained may be deducted; if used chiefly for pleasure, no depreciation deduction is allowable."

Bul. "F" Page 7, "Depreciation of personal residence.—Depreciation of a building occupied by a taxpayer as his personal residence is not deductible for income tax purposes. If a portion of the residence is used for business purposes, as in the case of a physician or any other professional man who has his office in his home, a proportionate part of the depreciation sustained may be deducted, the amount to be based generally on the ratio of the number of rooms used for business purposes to the total number of rooms in the building. . . ."

Bul. "F" Page 11, "Professional Libraries.—A professional man is entitled to deduct a reasonable allowance covering depreciation actually sustained on that part of his library which is necessary and used wholly in the pursuit of his profession, taking as a basis for such allowance, the fair market value as of March 1, 1913, if acquired to that date, or the cost, if acquired on or subsequent to that date. The cost of professional periodicals and books purchased by a business or professional man and having a temporary value, should be deducted as an expense of doing business, but the cost of volumes which have a more permanent value to the business or

profession, should be capitalized and made the subject of depreciation allowances."

PROBLEM 124

Illustrating Deductions Allowed—Depreciation—Basis (a) Economic Life Instead of Physical Life of Property (b) Apportionment over Units of Production

FACTS:

The W. & J. Lumber Co. in 1918 secured a contract to cut and saw the timber on a certain tract of land. The company erected buildings and installed the necessary equipment to perform the contract, which was estimated to require three years to complete. The tract of land was so situated that the cost of removal of the buildings after completing the contract would be prohibitive, and the buildings and equipment would have no value to the company other than their salvage value.

QUESTION:

How should the company compute depreciation on these assets, where the period of usefulness is less than the normal physical life of such assets?

ANSWER:

Under such conditions the capital sum (cost less salvage value) to be replaced by allowances for depreciation should be charged off on the basis of either the time required to complete the contract or the units of production.

REFERENCE:

See Problem 120 for law quotation, Sec. 234 (a) (7).

Bureau of Internal Revenue Bul. "F" page 31: "The cost of the property and equipment may be charged off and deducted as depreciation allowances on the basis of the time required to complete the contract, or in the proportion that the amount of timber cut and sawed each year bears to the total amount of timber available."

Bul. "F," page 13: "Prior to the passage of the Revenue Act of 1918, no deduction on account of obsolescence was permitted."

INDIVIDUALS:

While the above problem illustrates the principle as it applies to corporations, the same treatment as to the depreciation allowance would obtain in similar circumstances for individuals.

REFERENCE:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913;"

PROBLEM 125

Illustrating Depreciation of Intangible Property

FACTS:

Henry Schmidt purchased the business and assets of the Teutonic Brewing Company in January, 1914, paying therefor the sum of $1,500,000 in cash. An appraisal of the assets acquired at the time indicated that the intangible assets, i. e., good will, trade marks, trade brands, etc., had a value of $500,000. Mr. Schmidt continued the business of his predecessor under the name of the Teutonic Brewing Company. Because of the Eighteenth Amendment to the Constitution, the brewing company had to cease business on January 16, 1920. The net income of Mr. Schmidt from January 31, 1918, to January 16, 1920, was $600,000. On the basis of the income which Mr. Schmidt expected to derive in the period from January 31, 1918, to January 16, 1920, over and above a normal return on the tangible assets the value of the intangible assets on January 31, 1918, was $300,000. Mr. Schmidt filed returns for 1918, 1919, and 1920, on the calendar-year basis. No deduction had been claimed on account of depreciation of the intangible property by reason of prohibition legislation.

QUESTION:

Is Mr. Schmidt entitled to a deduction from gross income on

account of the depreciation of the good will and other intangible assets of his brewing business, and if so, how is such depreciation to be computed?

ANSWER:

While ordinarily taxpayers are not allowed a deduction from gross income on account of depreciation of good will or other similar intangible property, by reason of the special circumstances which exist in cases of this kind the Bureau has held that taxpayers are entitled to a deduction on account of such depreciation. Because of the status of prohibition legislation on January 31, 1918, the Bureau has ruled that good will and other intangible property of distillers, brewers, etc., was on January 31, 1918 reduced to the then present value of the income to be derived between that date and January 16, 1920. The value of the good will on January 31, 1918, may be depreciated on the basis of the time elapsed between that date and the date upon which prohibition became effective, namely, January 16, 1920. The computation of the depreciation deductions on account of the intangible assets is shown in the following:

The actual value on January 31, 1918, of the net income estimated to be derived from the intangible assets was $300,000. This amount, therefore, represents the value of the intangible assets as at January 31, 1918. The difference between this amount and $500,000 represents the depreciation which had fully accrued on January 31, 1918 ($200,000).

This $200,000 is deductible in the first taxable year ending on or after January 31, 1918; in this case the taxable year ended December 31, 1918. The remaining $300,000 is deductible as follows:

$\frac{11}{23\frac{1}{2}} \times \$300,000 = \$140,425.53$ for the taxable year 1918

$\frac{12}{23\frac{1}{2}} \times \$300,000 = \$153,191.49$ for the taxable year 1919

$\frac{\frac{1}{2}}{23\frac{1}{2}} \times \$300,000 = \$\ \ 6,382.98$ for the period Jan. 1 to Jan. 16, 1920.

Total.............	$300,000.00		
1918 taxable year	200,000.00		
	$500,000.00		
Amounts to be written off in 1918:		$200,000.00	
		140,425.53	
			$340,425.53
Amount to be written off in 1919:............			153,191.49
Amount to be written off in 1920:............			6,382.98
			$500,000.00

It is to be noted that in the above the value of the good will on January 31, 1918, is depreciated on the basis of the portion of the interval in each taxable year between January 31, 1918, and January 16, 1920, or eleven months for 1918, twelve months for 1919, and one-half month for 1920, making a total of 23½ months.

REFERENCES:

Art. 163, Reg. 62: "Depreciation of intangible property.—Intangibles, the use of which in the trade or business is definitely limited in duration, may be the subject of a depreciation allowance. Examples are patents and copyrights, licenses and franchises. Intangibles, the use of which in the business or trade is not so limited, will not usually be a proper subject of such an allowance. If, however, an intangible asset acquired through capital outlay is known from experience to be of value in the business for only a limited period, the length of which can be estimated from experience with reasonable certainty, such intangible asset may be the subject of a depreciation allowance, provided the facts are fully shown in the return or prior thereto to the satisfaction of the Commissioner."

See also Bul. 15–19–445; T. B. R. 44. Also Bul. "F," page 15.

PROBLEM 126

Illustrating Case in Which Amortization Deduction is Allowable

FACTS:

The Minnesota Wisconsin Milling Company, in order to meet a very greatly increased demand for its product as the result of the late war, expended $400,000 in the construction of plant and equipment. These expenditures were made subsequent to April 6, 1917, and prior to the signing of the Armistice on November 11, 1918. The company had no contracts directly with the Government. However, its product was considered an absolute necessity and it was given the usual priority accorded to necessities during the war. The company is about to file its 1921 return and finds that it has never made claim for the amortization of any part of its war construction. As the result of a survey made during January, 1922, it finds that it has facilities for manufacture far in excess of its requirements at that time, and it estimates that such facilities will be greatly in excess of the requirements of the company for at least several years to come.

QUESTION:

Is the company entitled to a claim for amortization, and, if so, what steps should it take in connection with such claim?

ANSWER:

As the plant and equipment above referred to constructed after April 6, 1917, was constructed for the production of articles contributing to the prosecution of the war against the German Government, the corporation is entitled to a reasonable deduction for the amortization of such property. As the company has made no prior claim for amortization it should make claim at the time of filing its 1921 income tax return. This claim should be supported by full details in accordance with the requirements of the Bureau of Internal Revenue. Upon an

investigation of the company's claim by the Bureau's engineers the Treasury Department will determine the amount of amortization, if any, to be allowed as well as the period over which the amortization allowance is to be spread.

References:

Sec. 234 (a) (8): "In the case of buildings, machinery, equipment, or other facilities, constructed, erected, installed, or acquired, on or after April 6, 1917, for the production of articles contributing to the prosecution of the war against the German Government, and in the case of vessels constructed or acquired on or after such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for any taxable year ending before March 3, 1924, (if claim therefor was made at the time of filing return for the taxable year, 1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as has been borne by the taxpayer, but not again including any amount otherwise allowed under this title or previous Acts of Congress as a deduction in computing net income."

Cf. Bul. 16-19-464; O. D. 259: "Machinery, equipment, or other facilities erected or acquired on or after April 6, 1917, for the production or manufacture of sugar is considered as contributing to the prosecution of the war, and the cost may be amortized in accordance with the provisions of section 234 (a) 8 of the Revenue Act of 1918."

Note:

The allowance for amortization in the case of individuals is governed by the same rules and regulations as in the case of corporations. See section 214 (a) (9), which reads exactly the same as section 234 (a) (8), quoted above.

PROBLEM 127

Illustrating Redetermination in Case Amortization Claim Has Been Allowed

Facts:

The Bridgeport Machine Tool Company in filing its return for the year 1918, claimed amortization in the amount of $150,000, on account of war facilities. Engineers of the Amortization

Section of the Bureau of Internal Revenue in the winter of 1919, made a field examination of the company's equipment on account of which the amortization above mentioned was claimed. The engineers then found that the war facilities were being used by the company in connection with its ordinary business and that from all appearances these facilities were used to full capacity. Accordingly the Bureau disallowed the claim of the company for amortization of its war facilities and allowed as a deduction only an amount which provided for depreciation. During the year 1922 the Chairman of the Board of Directors of the company directed the Chief Engineer of the company to prepare a report of the extent to which the company's plants were idle. Such report showed that fully one-half of the plant capacity of the company was not in use.

QUESTION:

Is the corporation entitled to reopen its return for the year 1918, which had been fully audited by the Bureau and to restate its claim for amortization in the light of conditions which had developed subsequent to the examination of the company's return by the Bureau?

ANSWER:

The company may at any time before March 3, 1924, request the Commissioner to re-examine its returns and upon such request the Commissioner is required to so re-examine the return. If the Commissioner finds as a result of an appraisal or from other evidence that the disallowance of the amortization originally made as a result of the Bureau's audit is incorrect, the tax for 1918 is required to be redetermined.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (8) . . . At any time before March 3, 1924, the Commissioner may, and at the request of the taxpayer shall, re-examine the return, and if he then finds as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits, and excess-profits taxes for the

year or years affected shall be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252."

NOTE:

The same provision is made under section 214 (a) (9) applying to individuals.

PROBLEM 128

Illustrating Case in Which Amortization is not Allowed even Though Property was Acquired Subsequent to April 6, 1917, and for Purposes Contributing to the Prosecution of the War against the German Government

FACTS:

The Boonville Railroad Company in 1917, and subsequent to April 6, of that year, laid a line from Boonville to Munitionstown. At Munitionstown there was located a large plant which was turning out munitions for the United States Government and which was operated by the Munitions Company. The sole purpose of the line laid by the railroad company was to furnish transportation to the employees of the Munitions Company to and from their homes in Boonville. The company expended $40,000 on this line, which several months after the signing of the Armistice, became practically worthless. No claim has heretofore been made by the company for amortization.

QUESTION:

Is the railroad company entitled to an amortization allowance for the property above mentioned?

ANSWER:

In a similar case the Bureau has ruled that as the railroad line was not constructed for the purpose of manufacture or production of articles contributing to the prosecution of the war against the German Government, but was constructed for

the purpose of furnishing transportation, the taxpayer was not entitled to a deduction for amortization. The reference in the statute to the transportation of articles or men contributing to the prosecution of such war applies only in the case of vessels constructed or acquired after April 6, 1917. Accordingly, under the present rulings in the Bureau no deduction will be allowed the Boonville Railroad Company on account of amortization.

Reference:

Bul. 45–21–1909; L. O. 1074: "A claim for amortization on additional facilities which were acquired and built by a railroad subsequent to April 6, 1917, to meet the additional demands upon such road arising out of the prosecution of the war is not within the statute and must be denied. . . . It is held that where railroads constructed additional track, lines, sidings, stations, roundhouses and repair shops and purchased additional locomotives and cars in order to meet the demands on such roads, occasioned by the war, no allowance may be made for amortization as those facilities do not fall within the classes enumerated in section 234 (a) 8 of the Revenue Act of 1918. . . ."

Note:

The author is inclined to the opinion that the Bureau's construction of the law with respect to a case of the kind above referred to, is ultra-technical. The author feels that there is sufficient room and ground for an interpretation of the amortization provision permitting taxpayers in cases such as given above, to be allowed amortization deductions.

PROBLEM 129

Illustrating Basis of Depletion Allowance for Lessor and Lessee—Bonus or Advanced Royalty

Facts:

Allen Bush purchased ore properties for $60,000, June 6, 1914, when they had an estimated ore content of 50,000 tons. On December 1, 1916, he leased the properties (for the life of the

mines) to John Locke for a payment of $20,000 down and 75¢ per ton royalty for all the ore extracted from the properties. Up to this time the properties had not been operated. The ore content on December 1, 1916, was still estimated to be 50,000 tons. The lease contained appropriate clauses providing for the continuous operation of the properties, etc. Beginning with 1917, John Locke extracted 5,000 tons of ore each year.

QUESTION:

To what depletion deductions would Mr. Bush and Mr. Locke, respectively, be entitled in 1921?

ANSWER:

The bonus received by Mr. Bush is regarded as reducing the capital sum to be recovered by him through depletion. The remaining capital sum is therefore $40,000, on the basis of which the depletion unit is 80¢ per ton. 5,000 tons of ore having been removed in 1921, the depletion deduction to which Mr. Bush is entitled is 5,000 times 80¢, or $4,000.

The bonus paid by Mr. Locke is in his case the basis for the depletion to which he is entitled. Having paid a bonus of $20,000, and the ore content at the date of acquisition of the lease by Mr. Locke being 50,000 tons, the depletion unit is 40¢ per ton, while the depletion deductible in 1921 is $2,000.

REFERENCES:

Art. 215 (a), Regulations 62: "Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition."

PROBLEM 130

Illustrating Determination of March 1, 1913, Value of Mining Properties Based on Ore Content and Anticipated Profits

FACTS:

The Cornwall Copper Company, which paid $500,000, for copper properties in 1910, determines from its records and from other sources the following information as of March 1, 1913: That the company was able to estimate the ore in sight at 1,500,000 tons; that the mine could reasonably be expected to earn a net profit of $200,000 annually ($1⅓ per ton mined); that the ore would be exhausted in ten years; and that the company was entitled to receive a return of 10% on the investment. Amounts set aside to amortize capital investment earn interest at the rate of 4%.

QUESTION:

What is the March 1, 1913, value of the properties, assuming that the so-called "present value" method is the only method available in arriving at this value?

ANSWER:

The present value of the properties as of March 1, 1913, would be $1,090,000. That is, of the annual profit of $200,000, there could be set aside annually into a sinking fund an amount which at 4 per cent compound interest would, by the time of the exhaustion of the mine, equal the March 1, 1913, value, or $1,090,000, and the remainder of the $200,000 would permit an annual dividend of 10% upon such sum of $1,090,000.

REFERENCE:

Art. 206 (b), Regulations 62: "To determine the fair market value of a mineral property by the present value method, the essential factors must be determined for each deposit included in the

property. The factors are (1) the total quantity of mineral in terms of the principal or customary unit (or units) paid for in the mineral product marketed, (2) the average quality or grade of the mineral reserves, (3) the expected percentage of extraction or recovery in each process or operation necessary for the preparation of the crude mineral for market, (4) the probable operating life of the deposit in years, (5) the unit operating cost, i.e., cost of production exclusive of depreciation and depletion, and (6) the rate of interest commensurate with the risk for the particular deposit. When the deposit has been sufficiently developed these factors may be determined from past operating experience. In the application of factors derived from past experience full allowance should be made for probable future variations in the rate of exhaustion, quality or grade of the mineral, percentage of recovery, cost of production, and selling price of the product marketed during the expected operating life of the mineral deposit."

PROBLEM 131

Illustrating Basis for Depletion of an Oil Well in Case of Discovery by Taxpayer after March 1, 1913

FACTS:

Henry Muldoon, an employee of a certain oil producing company in California, purchased in 1910, out of savings accumulated by him, a certain tract of farm land in the vicinity of a well-known oil well. He paid $2,000 for this tract. This tract was not known to contain oil but Henry Muldoon had a "hunch" that this purchase would bring him wealth. In 1918, Mr. Muldoon inherited $50,000 from an uncle. Mr. Muldoon resigned from the employ of the company for whom he had been working and forthwith commenced drilling operations on the farm which he purchased as mentioned above. On September 24, 1918 he struck oil, as a result of which the properties for which he paid $2,000 in 1910, had a fair market value on October 15, 1918 of $275,000. He operated the property from this date on through 1921. The depletion for 1921, based upon the fair market value of the property on October 15, 1918, was $47,000. The net income for 1921 from this property, without allowance for depletion, was $62,000.

QUESTION:

In computing the depletion for 1921, to which Mr. Muldoon is entitled as a deduction from gross income, what value is to be used as the basis?

ANSWER:

As the oil wells were not acquired by Mr. Muldoon through the purchase of a proven tract or lease, but were discovered by him after March 1, 1913, as a result of which discovery the fair market value of the property within thirty days after such discovery was materially disproportionate to the cost, such fair market value is the basis for the depletion allowance.

REFERENCE:

Sec. 214 (a) (10) [also Sec. 234 (a) (9)]: "... That in the case of mines, oil and gas wells, discovered by the taxpayer on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: And provided further, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; ..."

PROBLEM 132

Illustrating Deductions from Gross Income—Depletion Deductible in Case Depletion Based on Cost (or March 1, 1913 Value) Lower than, and Depletion Based on Discovery Value Higher than, Net Income Before Deducting Depletion

FACTS:

H. M. Dune on March 1, 1913, purchased a certain piece of mining property, the ore content of which at that time was valued at $10,000. Subsequent discoveries on the property proved the ore content to be worth $300,000, which was the value within thirty days after discovery. During 1921 (the

first year of the operation of the property) one-twentieth of the total ore content was removed and used in operations, so that the depletion based on cost (March 1, 1913, value) was $500, and the depletion based on discovery value was $15,000. The net income from that particular piece of property, before deducting depletion, was $10,000.

QUESTION:

What amount of depletion on the above property is deductible in Mr. Dune's 1921 income-tax return?

ANSWER:

A literal interpretation of the statute would indicate that Mr. Dune is entitled to deduct $15,000. This interpretation, however, is seemingly contrary to the intent of Congress. The author's interpretation of this particular feature of the statute is that depletion based upon discovery value may not exceed the depletion based upon cost (or March 1, 1913, value) unless the depletion based upon cost (or March 1, 1913, value) is less than the net income from the property subject to depletion (computed without the benefit of a depletion deduction), in which case the depletion based upon discovery value may not exceed such net income.

Under the circumstances assumed as facts in this problem, since the net income (computed without allowance for depletion) is higher than depletion based on cost (or March 1, 1913, value) and lower than the depletion based on discovery value, the amount of depletion deductible is equal to such net income, or $10,000.

REFERENCES:

Sec. 214 (a) (10) [also Sec. 234 (a) (9)]: (Quoted under Problem 131).

Art. 201 (h), Reg. 62: "Depletion allowance in case of discovery: The deduction for depletion in case of a discovery can not exceed the net income computed without allowance for depletion, from the property upon which the discovery is made, except where and to the extent that such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913."

See Problem 36 (under Sec. 204).

PROBLEM 133

Illustrating Depletion of Mining Properties Acquired Prior to March 1, 1913—March 1, 1913, Value Equal to Cost

FACTS:

The Miles Mining Company was organized January 2, 1912. It issued its entire capital stock for $200,000 cash. The company then purchased iron mining properties consisting of 1,000 acres of ore lands and mining equipment. The cost of the ore property was $140,000 and the equipment $60,000. A survey of the ore properties at date of purchase indicated an ore content of 1,500,000 tons. The surface value of the land for purposes other than mining was $5 per acre. The value of the properties March 1, 1913, was equal to the cost and no discoveries resulting in a material appreciation of market value were made subsequent to March 1, 1913. In 1921, 150,000 tons of ore were extracted.

QUESTION:

What would be the basis for depletion in 1921 and the amount of depletion deductible?

ANSWER:

The depletion would be based upon the cost of the ore properties, $140,000, minus the surface value of the land, $5,000, applied to the estimated ore content at the date of purchase, 1,500,000 tons, which would give a depletion unit of 9¢ per ton. Since 150,000 tons were extracted in 1921, the deductible depletion would be $13,500.

REFERENCE:

Sec. 234 (a): "That in computing net income there shall be allowed as deductions: . . . (9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance

for depletion . . . based upon cost. . . . Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date."

See also Sec. 214 (a) (10) for like depletion allowance in the case of individuals.

PROBLEM 134

Illustrating Depletion of Mining Properties Acquired Prior to March 1, 1913—March 1, 1913, Value Greater Than Cost

FACTS:

The Minter Mining Company in 1921, extracted 15,000 tons of ore from its properties, which properties on March 1, 1913, had a fair market value of $215,000, as compared with a cost of $140,000. The estimated ore content of the properties on March 1, 1913, was 175,000 tons. The surface value of the properties on that date was $5,000.

QUESTION:

What is the basis for, and the amount of, depletion allowable as a deduction in 1921?

ANSWER:

The value per ton of ore in the ground for tax purposes would be based upon the March 1, 1913, fair market value of the properties, $215,000, minus the surface value, $5,000, applied to an estimated ore content of 175,000 tons which would give $1.20 per ton as the depletion unit. With an extraction of 15,000 tons of ore in 1921, the depletion deduction would be $18,000.

REFERENCE:

Sec. 234 (a) (9) and Sec. 214 (a) (10): (Quoted under Problem 133.)

PROBLEM 135

Illustrating Computation of Allowance for Depreciation of Mining Property

FACTS:

The Morris Mining Company has mine buildings and improvements on its ore properties costing $10,000. The ore properties have a value for depletion purposes of $75,000, based on an estimated content, at the basic date, of 100,000 tons of ore.

QUESTION:

Must the taxpayer depreciate the improvements on the basis of the amount of ore extracted from the properties in the taxable period or may rates of depreciation based upon the life of the particular equipment and structures be used?

ANSWER:

Assuming that the practice under the 1918 Revenue Act will be continued under the 1921 Act, the method to be used is optional with the taxpayer, that is, whether the improvements and capital additions are depreciated in the taxable period in an amount equal to the portion of their cost or March 1, 1913, value if acquired prior thereto, represented by the ratio of ore extracted in the taxable period to the total ore content in the properties at the basic depletion date, or whether specific rates of depreciation based upon the life of the equipment shall be applied to the cost or March 1, 1913, value if acquired prior to that date. In the use of either method, however, the salvage value of the equipment must not be lost sight of.

REFERENCE:

Art. 224 (b), Regulations 62: "It shall be optional with the taxpayer, subject to the approval of the Commissioner, (1) whether the value of the mining property plus allowable capital additions but minus estimated salvage value shall be recovered at a rate established by current exhaustion of mineral, or (2) whether the value of the mineral deposit on the basic date plus allowable capital addi-

tions shall be recovered through depletion and the cost of plant and equipment less the estimated salvage value shall be recovered by reasonable charges for depreciation . . . at the rate determined by its physical life or its economic life or, according to the peculiar conditions of the case, by a method satisfactory to the Commissioner."

PROBLEM 136

Illustrating Deductions Allowed Individuals—Contributions

FACTS:

James Forbes, a resident of the United States, had a net income for the taxable year 1921, of $20,000, before deducting contributions. During the year he made the following donations and contributions:

1. $100 Knights of Columbus
2. 100 United Hospital
3. 100 St. Paul's Church
4. 500 New York University
5. 50 Post ——, American Legion
6. 25 Society for the Prevention of Cruelty to Children
7. 125 Community Fund (covering all charities of the City)
8. A plot of ground to the Y. M. C. A. on which it intended to erect a gymnasium. It was assessed at $8,500 and cost $6,000 in 1915.
9. A plot of ground to the City of Yonkers, N. Y., for use as a public playground. This plot was assessed at $2,500 by the city and cost $1,800 in 1914.
10. $200 To a distant relative in poor circumstances.

QUESTIONS:

Which of these contributions satisfies the requirements as to deductible contributions? What amount may Mr. Forbes take as a deduction from gross income?

ANSWER:

The first nine of the contributions or gifts listed above satisfy the requirements as being allowable deductions. In the case of the gifts of land to the Y. M. C. A., and to the City of Yonkers, N. Y., the cost is the basis for computing the amount of the gifts. The gift to the distant relative is not deductible. However, as the total is more than 15% of his net income before deducting contributions, the amount allowable as a deduction would be 15% of $20,000, or $3,000.

REFERENCES:

Sec. 214 (a): "That in computing net income there shall be allowed as deductions: . . . (11) Contributions or gifts made within the taxable year to or for the use of: (a) The United States, any State, Territory, or any political subdivision thereof, or the District of Columbia, for exclusively public purposes; (b) any corporation or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including posts of the American Legion or the Women's Auxiliary units thereof, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; or (c) the special fund for vocational rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. . . . Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;"

Art. 251, Regulations 52: ". . . Where the gift is other than money the basis for calculation of the amount of the gift shall be the cost of the property, if acquired after February 28, 1913, or its fair market value as of March 1, 1913, if acquired prior thereto, after deducting from such cost or value the amount sustained and allowable as a deduction in computing net income. . . ."

CORPORATIONS:

In general, Corporations are not permitted deductions for contributions.

REFERENCE:

Art. 562, Regulations 62: "Corporations are not entitled to deduct from gross income charitable or other contributions which individuals may deduct under paragraph 11 of section 214 (a). Donations made by a corporation for purposes connected with the operation of its

business, when limited to charitable institutions, hospitals, or educational institutions conducted for the benefit of its employees or their dependents, are a proper deduction as ordinary and necessary expenses. Donations which legitimately represent a consideration for a benefit flowing directly to the corporation as an incident of its business are allowable deductions from gross income. For example, a street railway corporation may donate a sum of money to an organization intending to hold a convention in the city in which it operates, with the reasonable expectation that the holding of such convention will augment its income through a greater number of people using the cars. . . . ."

PROBLEM 137

Illustrating Deductions from Gross Income—Group Insurance of Employees

FACTS:

The Style Dress Company, in analyzing its expenses for the taxable year 1921, finds that included in its expenses is an item of $1,352, annual premium on group insurance for its employees.

QUESTION:

Is such premium deductible from gross income?

ANSWER:

Yes, since as in the case of group insurance, the employer is not a beneficiary except as he may derive increased efficiency from his employees. The premium is therefore deductible.

REFERENCES:

Art. 294, Regulations 62: Where a ". . . . taxpayer is in no sense a beneficiary under such a policy, except as he may derive benefit from the increased efficiency of the officer or employee, premiums so paid are allowable deductions. . . ."

Bul. 12-20-793; O. D., 1014, held in part that "premiums paid for group life insurance constitute proper deductions under the head of 'ordinary and necessary expenses' in computing the net income of an employer, whether individual or corporation."

NOTE:

The same rule would apply in case the taxpayer were an individual instead of a corporation.

PROBLEM 138

Illustrating Items Not Deductible—Personal, Living or Family Expense

FACTS:

The books of account of J. Bole, investor, showed among others, the following charges during the year 1921:

1. Household expenses (groceries, fuel, etc.)	$2,350
2. Clothing (including tax $18)	438
3. Railroad fare, to and from office (including tax $24)	324
4. Rent of garage for personal use	240
5. Amusements and recreation (including tax $12)	132

QUESTION:

Are the above items deductible in Mr. Bole's income tax return?

ANSWER:

The various items of tax, totaling $54, are deductible. All of the balance of the amounts are not deductible.

REFERENCES:

Sec. 214 (a) (3): (Quoted under Problem 101.)

Sec. 215 (a): "In computing net income no deduction shall in any case be allowed in respect of—(1) Personal, living, or family expenses."

PROBLEM 139

Illustrating Items not Deductible—Damages Paid For Breach of Promise to Marry

FACTS:

U. V. White in 1921, under direction of the court, was required to pay $3,000 as damages for breach of promise to marry.

Mr. White undertakes to deduct the amount in his income tax return.

QUESTION:

Is the above item properly deductible for income tax purposes?

ANSWER:

No.

REFERENCES:

Bul. 24-20-1003; O. D. 546: "Amounts paid as damages for breach of promise to marry are considered personal expenses which are not deductible from the gross income of the taxpayer."

Sec. 215 (a) (1): (Quoted under Problem 138.)

PROBLEM 140

Illustrating Items not Deductible—Sums Paid Under Terms of Marriage Agreement—Alimony

FACTS:

W. W. White during the first six months of 1921, under the terms of a marriage agreement, pays out $1,800. During the last six months of the year he pays alimony amounting to $2,400.

QUESTION:

Is either of the above amounts deductible in Mr. White's income tax return?

ANSWER:

No.

REFERENCES:

Bul. 20-19-507; O. D. 275: "Sums paid to a wife under terms of a marriage agreement are considered payments in discharge of a personal obligation of the husband and are not deductible in computing his net income subject to tax."

Art. 291, Regulations 62: ". . . . Alimony and an allowance paid under a separation agreement are not deductible from gross income."

PROBLEM 141

Illustrating Items not Deductible—Fees Paid to Attorney in Defense of Prosecution for an Alleged Illegal Sale of Drugs

FACTS:

I. O. Dyne, a druggist, in 1921 was found guilty of illegally distributing certain drugs. In his effort to defend the case, Mr. Dyne paid attorney fees amounting to $2,000.

QUESTION:

Is the $2,000 a deductible item in Mr. Dyne's income tax return?

ANSWER:

The attorney fees are not deductible.

REFERENCES:

Bul. 25-21-1693; O. D. 952: "A taxpayer engaged in the retail drug business was indicted and tried for an alleged illegal sale of narcotics in connection with his business and was sentenced to pay a fine and to imprisonment. The case has been appealed and is still pending.

Held, that the attorney's fees paid are a personal expense and not an allowable deduction in computing net income."

Sec. 215 (a) (1): (Quoted under Problem 138.)

PROBLEM 142

Illustrating Items not Deductible—Expenses Incurred in Taking Post-graduate Course

FACTS:

George H. Golden, a practicing physician, in 1921 takes a post-graduate course in medicine preparatory to an examination which he must take in order to qualify to practice in a State other than the one in which he was previously practicing. His

tuition and expenses incident to taking the course amounted to $60.

QUESTION:

Is this expense deductible in Dr. Golden's income tax return?

ANSWER:

No.

REFERENCES:

Bul. 31-21-1755; O. D. 984: "Expenses incurred by doctors in taking post-graduate courses are deemed to be in the nature of personal expenses and not deductible."

Sec. 215 (a) (1): (Quoted under Problem 138.)

PROBLEM 143

Illustrating Items Not Deductible—State Examination Fees

FACTS:

Dr. George H. Golden, a practicing physician, in order to practice in a State other than that in which he has been practicing, is required to pass the State examination. The examination fees and the traveling and other expenses incurred by him in taking the examination amounted to $50.

QUESTION:

Is this expense deductible in Dr. Golden's income-tax return?

ANSWER:

No. His case is parallel to that of a certain attorney, in whose case similar expenses were considered by the Bureau to be in the nature of capital expenditures, and therefore not deductible.

REFERENCE:

Bul. 15–20–849; O. D. 452: "State bar examination fees and traveling expenses incurred and paid by a lawyer in securing admission to practice his profession are in the nature of capital expenditures and may not be deducted from gross income."

PROBLEM 144

Illustrating Items Not Deductible—Amounts Spent for Permanent Improvements.

FACTS:

Mr. A. Jones, hardware merchant in order to be able to take care of his increased business and to extend his business still further, makes a permanent addition to his store building, and makes certain improvements in his old building.

QUESTION:

Are the amounts spent in effecting these permanent additions and improvements deductible in Mr. Jones' tax return?

ANSWER:

No.

REFERENCE:

Sec. 215 (a): "In computing net income no deduction shall in any case be allowed in respect of . . . (2) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

NOTE:

Although the above problem as prepared relates to an individual, the same solution would apply in the case of a corporation. Reference: Sec. 235: "In computing net income" of corporations "no deduction shall in any case be allowed in respect of any of the items specified in section 215."

PROBLEM 145

Illustrating Items not Deductible—Amounts Expended in Defending Title to Property

FACTS:

J. Lawrence McMaster in 1921, spends $2,500 in defending title to business property which he owns.

QUESTION:

Is this amount deductible in Mr. McMaster's income tax return?

ANSWER:

No.

REFERENCE:

Art. 293, Regulations 62: "The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense."

NOTE:

While the above problem as prepared relates to an individual, the same answer would apply in the case of a corporation.

PROBLEM 146

Illustrating Items not Deductible—Fees Paid for Services in Securing Reduction of Assessment for Street Improvement

FACTS:

F. Flanders, paper manufacturer, in 1921 was assessed $1,000 for street improvement along his factory. Through the services of an attorney Mr. Flanders obtained a reduction of the assessment to $600. The attorney charged Mr. Flanders $100 for the service rendered.

QUESTION:

Is the $100 expended in obtaining the reduction in the amount of the assessment a deductible item in Mr. Flander's income tax return?

ANSWER:

No.

REFERENCES:

Bul. 48-20-1324; O. D. 739: "The fees paid by a property owner

to an attorney for his services in securing a reduction of an assessment imposed for a local benefit are not a proper deduction as a business expense. As such fees were paid to reduce a necessary capital expenditure in connection with the property against which the assessment was levied, they constitute a part of such capital expenditure, and hence are to be considered a part of the cost price of the property for the purpose of determining gain or loss in event of its sale."

Sec. 215 (a) (2): (Quoted under Problem 144.)

NOTE:

The rule is the same whether the taxpayer is an individual or a corporation. Reference: Sec. 235: "In computing net income" of corporations "no deduction shall in any case be allowed in respect of any of the items specified in section 215."

PROBLEM 147

Illustrating Items not Deductible—Brokerage—Legally Declared Dividends Voluntarily Returned—Assessment Against Stockholders.

FACTS:

J. J. Wiles in January, 1921, pays commissions amounting to $50 in acquiring certain shares of stock. In June dividends were legally declared and paid; but in October by agreement with the other stockholders in the company, the dividend was voluntarily returned in order to avoid impairment of the capital. In December, 1921, each stockholder is assessed $20 per share for the purpose of reorganizing the company.

QUESTION:

Which, if any, of the above items are deductible in Mr. Wiles' income tax return?

ANSWER:

None.

REFERENCES:

Art. 293, Reg. 45 Revised: "Commissions paid in purchasing securities are a part of the cost price of such securities. . . . Amounts

to be assessed and paid under an agreement between bondholders or stockholders of a corporation, to be used in a reorganization of the corporation, are investments of capital and not deductible for any purpose in returns of income."

Bul. 25-21-1691; Sol. Op. 110: "It is accordingly held that where a corporation legally declares and pays a dividend which is later voluntarily returned by the stockholders in order to avoid impairment of its capital the amount of such dividend (1) is subject to surtax in the year in which received by an individual stockholder and (2) being a contribution to capital may not be deducted from gross income of the stockholder in the year in which repaid to the corporation."

NOTE:

The rule would be the same, whether the taxpayer be an individual or a corporation.

PROBLEM 148

Illustrating Deductions Allowed—Betterments by Lessees

FACTS:

David Brewer, an attorney, leased an office on Oct. 1, 1920, for a period of five years, agreeing to make any desired improvements or alterations at his own expense. It was also agreed that upon termination of the lease, the premises revert to the lessor with all improvements or alterations or at his option the lessor may require the lessee to remove them at his own expense and restore the premises to their original condition. Accordingly, Mr. Brewer made several alterations and improvements all of which had a life of over five years, which were completed and paid for January 2, 1921.

QUESTION I:

Is the cost of these changes deductible in Mr. Brewer's return for the calendar year 1921?

ANSWER:

No; they must be capitalized and even though they had a life of over five years the cost is to be returned through depreciation ratably over the life of the lease; the annual deductions being

$^{12}/_{57}$ of the cost for 1921, $^{12}/_{57}$ for 1922, $^{12}/_{57}$ for 1923, $^{12}/_{57}$ for 1924, and $^{9}/_{57}$ for 1925.

QUESTION II:

Would Mr. Brewer be permitted to set up as a reserve an estimate of the cost of removing the changes made (anticipating the possibility that the lessor may exercise the latter part of his option) deducting from gross income the annual credits to such reserve?

ANSWER:

No. Should Mr. Brewer be required to remove the improvements, etc., on Sept. 30, 1925, and restore the premises to their original condition, any expenses incurred thereby would be deductible in his return for 1925.

REFERENCES:

Art. 109, Regulations 62: ". . . The cost borne by a lessee in . . . making permanent improvements . . . is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation."

In Bul. 21-20-952; O. D. 516, the Bureau "Held, that the lessee may pro rate the cost of the alterations and improvements over the life of the lease and claim a suitable deduction each year, but that it may not set up a reserve to cover the cost of restoring the premises to their original condition. The expense of restoring the property at the expiration of the lease, if the lessee is required to restore it, will be an allowable deduction for the year in which it is actually incurred."

CORPORATIONS:

Corporations having the same conditions outlined in the case of the foregoing individual, would be permitted the same deductions for depreciation, and would not be permitted to deduct from gross income any credits to a reserve set up to cover the possibility of removing the betterments at the expiration of the lease.

PROBLEM 149

Illustrating Items not Deductible—Amounts Spent in Restoring Property.

FACTS:

Dr. Molar of Hartville, Missouri, a dental surgeon in his 1921 return, claims a deduction of $850 as depreciation on his office building. He had taken this amount as depreciation each year since the income tax acts became effective, and the amount has in the past been regarded by the Bureau as reasonable.

In 1921 Dr. Molar expended $3,400 in restoring the office building to a condition almost as good as new. He also claimed this amount as a deduction.

QUESTION:

Do both the above items constitute proper deductions?

ANSWER:

A reasonable amount for depreciation will be allowable as a deduction but the taxpayer will not be allowed the deduction of the amount expended in restoring the property.

REFERENCES:

Sec. 214 (a) (8): (Quoted under Problem 120.)

Sec. 215 (a): "That in computing net income no deduction shall in any case be allowed in respect of . . . (3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."

NOTE:

The application of this section of the statute is the same whether the taxpayer be an individual or a corporation. Reference: Sec. 235: "In computing net income" of corporations "no deduction shall in any case be allowed in respect of any of the items specified in section 215."

PROBLEM 150

Illustrating Items not Deductible—Materials Used by Absconding Contractor Left Unpaid

FACTS:

A. White, in his tax return for 1921, takes a deduction of $800 to cover an amount paid by him, by order of court, on a bill for materials used by a contractor in erecting a store building for Mr. White. The contractor, who was to pay for all materials used, had absconded, leaving the bill unpaid.

QUESTION:

Is Mr. White correct in deducting the $800 from his taxable income?

ANSWER:

No.

REFERENCE:

Bul. 21-21-1651; O. D. 925: "A taxpayer employed a contractor to build his house. The contractor absconded, leaving certain bills for materials used in the construction of the house unpaid, and the taxpayer was required to pay such bills. Held, that the additional amount paid represents additional cost of the building and is not deductible."

NOTE:

The application of the rule would be the same whether the taxpayer be an individual or a corporation.

PROBLEM 151

Illustrating Items not Deductible—Premium on Employee's Life Where Taxpayer is Beneficiary Under the Policy

FACTS:

Wm. Kessler, a practicing attorney, in 1921 pays a premium of $150 on an insurance policy covering the life of his assistant.

Mr. Kessler is the beneficiary under the policy.

QUESTION:

Is this premium deductible in Mr. Kessler's income tax return?

ANSWER:

No.

REFERENCE:

Sec. 215 (a): "In computing net income no reduction shall in any case be allowed in respect of . . . (4) Premiums paid on any life insurance policy, covering the life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy."

NOTE:

Although the above problem as prepared relates to an individual, the same answer would apply to a corporation. Reference: Sec. 235: "In computing net income" of corporations "no deduction shall in any case be allowed in respect of any of the items specified in section 215."

PROBLEM 152

Illustrating Non-Deductible Item—Diminution in Value of Life Estate

FACTS:

Mr. Louis Abbott by the will of Mr. Joseph T. Brady, his uncle, deceased, was to receive during the remainder of the former's life the income from certain high-grade bonds. At Mr. Abbott's death the bonds were to become the absolute property of his cousin, Miss Louise Channing. According to the mortality tables, Mr. Abbott's expectancy of life from the date of the decedent's death was 20 years. The value of Mr. Abbott's interest for life in the bonds above mentioned at the date of his uncle's death January 1, 1920, was $200,000.

In his income tax return for 1921, Mr. Abbott takes as a de-

duction $10,000, being one-twentieth of $200,000, on the ground that he is entitled to depreciate his life interest in the bonds, because of the shrinkage in value of such interest due to the lapse of time.

QUESTION:

Was Mr. Abbott within his rights in deducting this item?

ANSWER:

No.

REFERENCE:

Sec. 215 (b): "Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time. . . ."

PROBLEM 153

Illustrating Credits Against Net Income—Dividends

FACTS:

Henry Richards, who resides in Chicago, Ill., has retired from business. In addition to his income from other sources he received the following dividends which he has included in his return of gross income for the calendar year 1921, under the provisions of Sec. 213:

$5,250 U. S. Steel Corporation (Common stock)
$6,125 American Brake Shoe & Foundry Co. (7% Preferred stock)
$8,400 Brazilian Coffee Export Co. Ltd. (Common stock)
$ 280 Rio de Janeiro Telephone Co. (Foreign corporation)

Henry Richards, Jr., (his son) is president of the Brazilian Coffee Export Co., Ltd., and he notified his father that more than

90% of the gross income of that corporation for the three-year period ending Dec. 31, 1920, (being the close of the taxable year preceding the declaration of the dividend above mentioned) was from sources within the United States. The telephone company had no business in the United States.

QUESTION:

What credit against net income for normal tax is Henry Richards entitled to on account of dividends?

ANSWER:

$19,775, computed as follows:

$ 5,250	U. S. Steel Corporation (Common stock)
$ 6,125	American Brake Shoe & Foundry Co. (Preferred stock)
$ 8,400	Brazilian Coffee Export Co. Ltd. (Common stock)
$19,775	

Only dividends from domestic corporations that are not entitled to the benefits of Sec. 262 (see Problem 161 for illustration of this condition) and from foreign corporations more than half of whose income for the three-year period ending with the close of the taxable year preceding the date of declaration of the dividend involved was from sources within the United States, are to be taken as credit against net income for normal-tax purposes.

REFERENCE:

Sec. 216: "That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (2) from a foreign corporation when it is shown to the satisfaction of the Commisioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;"

NOTE:

Under the Revenue Act of 1918, a taxpayer was entitled to a credit against net income for dividends received from foreign corporations where such corporations were taxable on income from sources within the United States, no matter how small the taxable income, (Bul. 5-19-252, T. B. M. 21) nor how large the dividends (Bul. 4-20-706; O. D. 383).

PROBLEM 154

Illustrating Credits Against Net Income for Normal Tax—Personal Exemption—Head of Family with Net Income Less than $5,000

FACTS:

James Dare, a citizen of the United States, has a widowed mother, a sister 19 who attends college, and a brother 16. The family lived during the entire calendar year 1921 in the house left by the father. The mother receives $125 annually from investments and has no other income except $250 which James Dare contributes monthly to the support of the family, out of his annual salary of $3,600, his sole income. The sister and the younger brother are entirely dependent upon their older brother and their mother. Mr. Dare's return is filed on the calendar-year basis.

QUESTION:

On what amount would he be subject to normal tax?

ANSWER:

$300. As he contributes 24⁄25 of the income of his dependents —mother, sister, and brother—and on the last day of his taxable year they are living in the one house which he maintains, he is considered the "head of a family," and, as such, is entitled to a personal exemption of $2,500 (his net income being less than $5,000). As the sister is over 18, and is not mentally or physically incapable of self-support, he is not entitled to credit

for her dependency. He is entitled, however, to claim the credit of $400 for each of the other two dependents—mother and brother under 18—giving him a total exemption of $3,300, leaving $300 subject to normal tax.

REFERENCES:

Sec. 216 : "That for the purpose of the normal tax only there shall be allowed the folowing credits: . . . (c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of the family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. . . . (d) $400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent person is under eighteen years of age or is incapable of self-support because mentally or physically defective; . . ."

Art. 302, Regulations 62: "A head of a family is an individual who actually supports and maintains in one household one or more individuals who are closely connected with him by blood relationship, relationship by marriage or by adoption, and whose right to exercise family control and provide for these dependent individuals is based upon some moral or legal obligation. . . ."

Art. 304, Regulations 62: "A taxpayer receives a credit of $400 for each person (other than husband or wife), whether related to him or not and whether living with him or not, dependent upon and receiving his chief support from the taxpayer, provided the dependent is either (a) under eighteen or (b) incapable of self-support because defective. The credit is based upon actual financial dependency and not mere legal dependency. It may accrue to a taxpayer who is not the head of a family. . . ."

Bul. 3-21-1397; O. D. 775, held in part that "In order to meet the test of actual support and maintenance within the purview of Art. 302, the benefactor must furnish more than one-half of the support and maintenance."

PROBLEM 155

Illustrating Credits Against Net Income for Normal Tax—Personal Exemption—Head of Family with Net Income Over $5,000.00

FACTS:

Frank Reed is in business as a hardware merchant. He is not married. His net income for his fiscal year ending November

30, 1921, was $105,000. Upon the death of his brother-in-law on September 3, 1921, who died without any provision for the support of his wife and their three children, aged 9, 12, and 14, respectively, Mr. Reed brought his sister and family to live with him, and provided their entire support thereafter.

QUESTION:

What would be his personal exemption on his return for the fiscal year ending Nov. 30, 1921?

ANSWER:

$3,200. He is the "head of a family" on the last day of his established fiscal year—November 30, 1921,—because he maintains in the one household these individuals who are closely related to him and their support is based on a moral obligation. As his net income is considerably more than $5,000, the exemption of but $2,000 applies. As in addition he contributes the entire support and maintenance of the sister and of her three children, all of which children are under eighteen, he is entitled to a further credit for each of them of $400, making a total exemption of $3,200.

REFERENCES:

Sec. 216. See Problem 154 for quotations from law and Reg. 62.

Bul. 26-21-1707, A. R. R. 551: ". . . Recommended that . . . an additional exemption . . . on account of a nephew and nieces, all under eighteen years of age, who resided in his own home and were dependent upon him for support and maintenance . . . be allowed in full. . . ."

PROBLEM 156

Illustrating Credits Against Net Income for Normal Tax—Personal Exemption—Credit for Dependent Other than Relative

FACTS:

Henry Dodd, an American citizen and a bachelor with an income of over $5,000, has provided the entire support of an old

family servant of his mother for the past taxable year, including the last day of such taxable year. The old servant was incapable of self support.

QUESTION:

Would his personal exemption of $1,000 be increased $400 because of his support of this old servant?

ANSWER:

Yes. The credit for dependents is based upon the dependent receiving his chief support from a taxpayer who is an American citizen or resident, if such dependent is under 18 or incapable of self-support. It is not necessary for the dependent to reside with the benefactor or be related, if the other two conditions are fulfilled.

REFERENCES:

Sec. 216: See Problem 154 for quotations from law and Regs. 62.

Bul. 4-19-220; O. D. 139: "An American citizen may claim the credit for dependents irrespective of the nationality or place of residence of the dependents."

PROBLEM 157

Illustrating Credit Against Net Income for Normal Tax—Personal Exemption—Nonresident Alien

FACTS:

Henry Cook is a nonresident alien. On the last day of his taxable year he was living abroad with his wife and their two minor children. He receives an income of over $5,000 from investments in property within the United States.

QUESTION:

What personal exemption is he entitled to claim as a credit against net income for normal tax purposes?

ANSWER:

As he is a nonresident alien as to the United States, he is

entitled to a personal exemption of but $1,000.00 and receives no credit for dependents.

REFERENCE:

Sec. 216: "That for the purpose of the normal tax only there shall be allowed the following credits: . . . (d) $400 for each person (other than husband or wife) dependent upon and receiving his chief support from the taxpayer if such dependent is under eighteen years of age or is incapable of self-support because mentally or physically defective; (e) In the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000 and he shall not be entitled to the credit provided in subdivision (d). . . ."

PROBLEM 158

Illustrating Credits Against Net Income for Normal Tax—Personal Exemption—Status on Last Day of Taxable Year

FACTS:

Richard Kellog, a citizen of the United States, is a widower with no dependents on Dec. 31, 1921, his wife and only child having been killed in an automobile accident on December 30, 1921. Mr. Kellog files his income tax return on the calendar-year basis.

QUESTION:

What personal exemption is he entitled to claim as a credit against net income for normal tax purposes for the year 1921?

ANSWER:

$1,000.00. Although he was married (and presumably living with his family) for the greater part of the year, his status on December 31, 1921,—the last day of the taxable year—was that of a single man, not the head of a family.

REFERENCE:

Sec. 216: "That for the purpose of the normal tax only there shall be allowed the following credits: . . .

(c) In the case of a single person, a personal exemption of $1,000; . . . (f) The credits allowed by subdivisions (c) . . . of this section shall be determined by the status of the taxpayer on the last

day of the period for which the return of income is made; . . ."

Art. 305, Regulations 62: "Date determining exemption.—The status of the taxpayer on the last day of his taxable year determines his right to an additional exemption and to a credit for dependents . . . an unmarried individual or a married individual not living with husband or wife, who during the taxable year has ceased to be the head of a family or to have dependents, is entitled only to the personal exemption of $1,000 allowed a single person. . . ."

PROBLEM 159

Illustrating Taxability of Interest Received by Nonresident Alien Individual not Engaged in Business in the United States

FACTS:

F. Froner, a subject of Holland residing in that country and having no office or place of business in the United States, receives the following income from his investments in the United States:

1. Interest on railroad bonds	$15,000
2. Interest on money loaned on mortgages	1,000
3. Interest on bank deposits	2,000
4. Interest from obligations of a resident foreign corporation more than 20% of whose gross income for three years prior to the close of its taxable year was earned within the United States	2,000
	$20,000

QUESTION:

What portion of this total is subject to United States income taxes?

ANSWER:

$18,000. Items 1, 2, and 4 are taxable; item 3 is exempt from tax.

REFERENCES:

Sec. 213 (c): "In the case of a nonresident alien individual, gross

income means only the gross income from sources within the United States, determined under the provisions of section 217.

Sec. 217 (a): "That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States:

1. Interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise, not including (a) *interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein,* or (b) Interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable; . . ."

NOTE:

The taxability of interest in the case of a foreign corporation (other than an insurance company) would be the same as in the case of a nonresident alien individual as shown above. Reference: Sec. 233 (b) (Quoted in full under Problem 216).

PROBLEM 160

Illustrating Case in Which a Citizen of the United States is Not Subject to Tax on Income within the United States

FACTS:

H. R. Gould, a citizen of the United States, has for the last five years resided and carried on business in the Philippines. He derived over 80 per cent of his total gross income from all sources in this period from within the Philippines, as the result of the active conduct of his business therein. During the calendar year 1921 (his accounting period is the calendar year) he received in addition to his income from his business $2,000, interest on bank deposits in the National City Bank in New York City. He also receives $4,000 interest on money loaned to the Roumanian Metal Company, a foreign corporation doing busi-

ness in the United States (less than 20% of whose gross income during each of the last five years was derived from sources within the United States). Mr. Gould has no office or place of business in the United States.

QUESTION:

Is the interest received by Mr. Gould from the National City Bank and from the Roumanian Metal Company subject to United States income taxes?

ANSWER:

No. Mr. Gould comes within the provisions of section 262 and as such must report his income from within the United States on the same basis as a nonresident alien. Therefore the interest received is not subject to tax in accordance with section 217 (a) (1).

REFERENCE:

Sec. 217 (a) (1): (Quoted under Problem 159.)

PROBLEM 161

Illustrating the Taxability of Dividends Received by a Nonresident Alien Individual

FACTS:

J. J. Lloyd, a subject of Great Britain residing in Canada, in 1921 receives dividends on stocks in the following corporations, in the amounts indicated:

1. The Imperial Corporation, a foreign corporation doing all its business in Canada	$ 5,000
2. Canadian Paper Company, a foreign corporation deriving 50 per cent of its gross income (for the three-year period ending with the close of its taxable year preceding the declaration of these dividends) from sources within the United States	6,000

3. The Porto Rico Pineapple Co., a domestic company doing all its business in Porto Rico	7,000
4. Pennsylvania Railroad Co., (not entitled to benefits of Sec. 262)	8,000
Total dividends received	$26,000

QUESTION:

What portion of the above income is subject to the United States income taxes?

ANSWER:

The taxable portion is $14,000, the total of items 2 and 4. Item 2 is taxable since dividends received from a foreign corporation deriving 50 per cent or more of its gross income from sources within the United States are treated as income from sources within the United States.

Item 3 is not taxable as it was received from a corporation which comes within the provisions of section 262, and therefor is exempted by Sec. 217 (a) (2).

REFERENCES:

Sec. 213 (c): (Quoted in full under Problem 159.)

Sec. 217 (a): "That in the case of a nonresident alien individual or of a citizen entitled to the benefits of section 262, the following items of gross income shall be treated as income from sources within the United States: . . . .

(2) The amount received as dividends (a) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (b) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section;"

NOTE:

The taxability of dividends in the case of a foreign corporation

(other than an insurance company) would be the same as in the case of the nonresident alien individual shown above.

REFERENCE:

Sec. 233 (b): "In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by section 243 or 246) in the manner provided in section 217."

PROBLEM 162

Illustrating the Deductibility of Losses and Expenses from Gains Derived Within the United States with Respect to Returns of Nonresident Aliens

FACTS:

William Hoffstaber, a German subject living in Hamburg, in the calendar year 1921 derives income from sources within the United States as follows:

Dividends of domestic corporations (not entitled to benefits of Sec. 262)	$25,000
Rentals from property	25,000
Royalties from patents	25,000
	$75,000

He pays to his agents in Berlin $5,000 per year for looking after the investments in the United States. Other charges which were paid to persons living in the United States were:

Janitor services on rental properties	$2,000
Collection charges	1,000
	$3,000

QUESTION:

What is the net income subject to tax in the United States?

Answer:

$67,000. Even though the $5,000 was paid to the agents living in Germany, the amount is a direct charge against income from sources within the United States, just as much as the $2,000 paid for janitor services and the $1,000 paid as collection charges.

Reference:

Sec. 217 (b): "From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto. . . . The remainder, if any, shall be included in full as net income from sources within the United States."

PROBLEM 163

Illustrating, in the Case of a Nonresident Alien Individual, the Deduction of Expenses Which Cannot be Definitely Allocated to Some Item or Class of Gross Income

Facts:

Hans Vandervoot, a subject of Holland residing in that country, conducts business in the United States and Holland. Fifty per cent of his gross income is derived from sources within the United States, and the balance from sources within his own country. His only office is located in Holland.

Question:

Can he deduct the general office expense, or any part thereof from the gross income which he reports for United States income tax purposes?

Answer:

Yes. He can deduct a ratable portion of his office expenses from the gross income derived from sources within the United States.

Reference:

Sec. 217 (b): "From the items of gross income specified in subdivision (a) there shall be deducted the expenses, losses, and other

deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States."

NOTE:

The above-quoted section relates to net income of a nonresident alien individual. In the case of a foreign corporation the treatment is similar to the above.

REFERENCE:

Sec. 234 (b): "In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary."

PROBLEM 164

Illustrating Taxability of Income by Nonresident Alien Derived from the Sale of Personal Property Produced in Part Within the United States and Completed and Sold Without the United States

FACTS:

R. H. Holmes, a British subject residing in Quebec, manufactures the parts of a certain make of automobile in the United States, and ships the parts to Canada to be assembled and sold. During the year 1921 Mr. Holmes derived a profit of $100,000 on the sale of the automobiles.

QUESTION:

Is all of this income exempt from tax in the United States?

ANSWER:

No. The net income was derived from sources partly within and partly without the United States. The income attributable

to sources within the United States will be apportioned by processes or formulæ prescribed by the Commissioner, and will be subject to the United States income taxes.

REFERENCE:

Sec. 217 (e): ". . . Gains, profits and income . . . (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States . . . shall be treated as derived partly from sources within and partly from sources without the United States."

NOTE:

The above-quoted section relates to the net income of non-resident alien individuals.

PROBLEM 165

Illustrating Taxability of Income by Nonresident Alien Derived From Sale of Personal Property Produced in Whole by the Taxpayer Without and Sold Within the United States

FACTS:

William Tell, a Swiss subject residing in Berne, manufactures toys in Switzerland and sends his entire output to his agent in the United States to be disposed of. Mr. Tell's net income from these operations in 1921 is $50,000.

QUESTION:

Is this income subject to the United States income taxes?

ANSWER:

It is only in part subject to the United States income taxes. The net income was made partly within and partly without the United States. The net income attributable to sources within the United States will be subject to the United States income taxes.

REFERENCE:

Sec. 217 (e): ". . . Gains, profits and income from . . . (2) . . . the sale of personal property . . . produced (in whole or in

part) by the taxpayer without and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. . . ."

PROBLEM 166

Illustrating Tax Liability of Individuals Doing Partnership Through the Purchase of Personal Property in a Foreign Country and Sale in the United States

FACTS:

M. A. Vivian, a French subject residing in Paris, purchased merchandise in France for $50,000, and shipped it to New York, where his agent sold the same for $75,000 net, Mr. Vivian realizing a profit of $25,000. This transaction occurred in 1921.

QUESTION:

Is the income taxable in the United States?

ANSWER:

Yes.

REFERENCE:

Sec. 217 (e) (2): ". . . Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property without and its sale within the United States shall be treated as derived entirely from the country in which sold."

NOTE:

The above section relates to the net income of nonresident alien individuals.

PROBLEM 167

Illustrating Tax Liability of Individuals Doing Partnership Business

FACTS:

Jones & Jones, two individuals, during 1921, carried on a business in partnership form.

QUESTION:

Is the partnership liable for income tax?

ANSWER:

No.

REFERENCE:

Sec. 218 (a): "That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. . . ."

PROBLEM 168

Illustrating Computation of Net Income of Individuals Carrying on Business as Partnership

FACTS:

(a) Brown & Brown, a partnership consisting of two equal partners, shows a net income of $20,000 for the calendar year 1921, its accounting year. Of this amount $14,000 has been distributed to the partners within the calendar year 1921. This is the only income of the partners, both of whom report on the calendar-year basis.

(b) Boyd & Boyd, a partnership consisting of two equal partners, shows a net income of $14,000 for its fiscal year ending June 30, 1921. The partners have income from other sources and make their returns on the calendar-year basis.

QUESTION:

What is the 1921 taxable net income from the partnership to be reported by the partners in each of the cases above stated?

ANSWER:

(a) Although only $14,000, was actually distributed, each partner must report as taxable net income his distributive share, whether distributed or not, in this case a total of $10,000 each.

(b) Since the two individuals file on a different basis from the partnership's accounting year, they must each add to their in-

come from other sources $7,000 of the partnership net income for the fiscal year ending June 30, 1921, which is the year ending within their taxable year.

REFERENCE:

Sec. 218 (a): "That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed."

PROBLEM 169

Illustrating Taxation of Partners on Partnership Income

FACTS:

The Rose & Rose Partnership's net income is $40,000 for the calendar year 1921. In this amount is included $10,000 cash dividends received from a domestic corporation (not itself a personal-service corporation) doing all its business in the United States, and $5,000 interest received on United States obligations issued since September 1, 1917. The partnership had deducted from its gross income in arriving at the net income above stated $1,000 for a donation to the Red Cross. The two partners share equally in the partnership profits. The partnership and both the partners report on the calendar-year basis.

QUESTION:

How are the partners to return their income from the partnership?

ANSWER:

Partnership net income $40,000

Add: Donation not an allowable deduction		1,000
		$41,000
Deduct income exempt from normal tax:		
Dividends domestic corporations	$10,000	
Interest United States obligations ...	5,000	15,000
		$26,000
One-half of above		13,000

To be reported by each partner as income from the Rose and Rose Partnership.

One-half of the total dividends received by the partnership, or $5,000, is to be reported by each partner as dividends exempt from normal tax; also one-half of the total interest received on the United States obligations, or $2,500, is to be added by each individual to the other interest received by him on United States obligations and of the total that part is to be reported which is not exempt from the surtax. The exemption of each individual is computed on the basis of his individual holdings in United States obligations plus one-half the partnership holdings in such obligations.

In computing his individual net income subject to the tax, one-half of the donation of $1,000 may be added by each partner to the donations made by him personally.

References:

Sec. 218: " . . . (b) The partner shall, for the purpose of the normal tax, be allowed as credits in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership. (c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph 11 of subdivision (a) of section 214 shall not be allowed."

Sec. 216: "That for the purpose of the normal tax only there shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (2) from a foreign corporation when it is

shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of section 217;

(b) "The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213."

Sec. 212: (Quoted under Problems 59 and 60.)

Sec. 214 (a) (11): (Quoted under Problem 136.)

Art. 251, Regulations 62: " . . . The proportionate share of contributions made by a partnership may be claimed as deductions in the personal returns of the partners to an amount which, added to the amount of such contributions made by the partner individually, is not in excess of 15 per cent of the partner's net income computed without the benefit of the deduction for such contributions. . . ."

PROBLEM 170

Illustrating Liability of Individual Stockholders of a Personal Service Corporation for 1921

FACTS:

The Samuel Business Service Company, a personal service corporation with three stockholders, shows a net income of $60,000 for the calendar year 1921. There was no dividend distribution during the year.

QUESTION:

How is this amount to be reported for United States Federal tax purposes in 1921?

ANSWER:

That corporation as such is not subject to income or profits tax. The individual stockholders must report their distributive shares of the income of the corporation for the year.

REFERENCE:

Sec. 218 (d): "Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. . . ."

"This subdivision shall not be in effect after December 31, 1921. . . ."

PROBLEM 171

Illustrating Taxability of the Net Income of a Personal Service Corporation Having a Fiscal Year Ending in 1922

FACTS:

The Talbot Company, a domestic personal service corporation, has a net income of $90,000, for its fiscal year ending June 30, 1922. The $400,000 par value outstanding capital stock of the corporation, according to the records, was held as follows:

Date	Stockholder	Par value held
July 1, 1921–Nov. 30, 1921	E. E. Talbot	$300,000
" "	J. G. Talbot	100,000
Dec. 1, 1921–Feb. 28, 1922	E. E. Talbot	240.000
" "	J. G. Talbot	80,000
" "	H. O. Talbot	80,000
Mar. 1, 1922–June 30, 1922	E. E. Talbot	200,000
" "	H. O. Talbot	200,000

A dividend of $20,000 was distributed out of the current fiscal year's earnings on October 15, 1921.

All of the above stockholders report on the calendar-year basis.

QUESTION:

How shall the $90,000 net income of the corporation be accounted for, for Federal income tax purposes?

ANSWER:

Of the $20,000 dividend distributed October 15, 1921, E. E. Talbot received three-fourths, or $15,000, and J. G. Talbot received $5,000.

The earnings of the corporation up to December 31, 1921,

were six-twelfths of $90,000, or $45,000, of which $20,000 had been distributed, leaving an undistributed balance of $25,000. This amount is allocable to the stockholders of record on December 31 in the ratio of their share holdings, i. e.,

E. E. Talbot	$\frac{240,000}{400,000}$, or 3/5, which is	$15,000
J. G. Talbot	$\frac{80,000}{400,000}$, or 1/5, which is	5,000
H. O. Talbot	$\frac{80,000}{400,000}$, or 1/5, which is	5,000
		$25,000

These amounts added to the amounts first shown above result as follows:

E. E. Talbot	$30,000
J. G. Talbot	10,000
H. O. Talbot	5,000

which amounts will be added to the income of the recipients from other sources in 1921, and the totals will be subject to the 1921 rates applying to individuals.

That portion of the $90,000 net income of the corporation which accrued after December 31, 1921, will be taxable in the hands of the corporation at 12½%.

Reference:

Sec. 218 (d): ". . . In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assignable to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act."

Sec. 205 (c): "If a fiscal year of a partnership . . . ends in 1922, then (1) the rates for the calendar year during which such

fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year. . . ."

PROBLEM 172

Illustrating Taxation of Income of Estates

FACTS:

John Jones is the executor of an estate holding domestic corporate stocks and bonds. The will contains a direction that A and B shall be paid during their lives annually the dividends from certain of the securities. In 1921 these dividends totaled $5,000. Of the remainder of the income $5,000 is to be distributed annually to specified legatees, and in 1921 $25,000 was to be donated (which was actually done) to the Red Cross. The gross income in 1921 including all the above amounts was $100,000, and the expense of operating the properties, $20,000.

QUESTION:

What is the taxable net income of the estate and by whom is it to be reported?

ANSWER:

The executor will make a return including the income of the estate which is not periodically distributable to or credited during the taxable year to beneficiaries or legatees. The net income is computed as follows:

Gross income		$100,000
Ordinary expenses for operating properties	$20,000	
Interest and dividends paid to beneficiaries and legatees under will	10,000	
Donation to Red Cross in accordance with will	25,000	55,000
Net income		$45,000

It will be noted that any part of the gross income paid or permanently set aside under the terms of the will may be deducted from taxable income. It is also to be noted that the donations are not subject to the 15% limitation imposed by Sec. 214 (a) (11).

REFERENCE:

Sec. 219 (a): "That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including (1) Income received by estates of deceased persons during the period of administration or settlement of the estate; . . . (4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals . . . (b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate, or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made."

Sec. 225 (a): "That every fiduciary (except a receiver appointed by authority of law in possession of part only of the property of an individual) shall make under oath a return for . . . . (4) Every estate or trust the net income of which for the taxable year is $1,000 or over."

PROBLEM 173

Illustrating Tax on Income of Trusts

FACTS:

The directors of the Sunshine Corporation voted to put in the hands of a trustee for the employees of the Company under a plan of distribution certain shares of the capital stock of the company. The trust indenture provided that the employees were

to pay par for the stock in small installments and that the dividends on the stock were to be paid to the trustee, the latter being required to credit the several employees with their respective proportions of the dividend as part payment for the stock.

QUESTION:

Is the trustee required to pay a tax on the income received by him?

ANSWER:

No.

REFERENCE:

Sec. 219 (f): "A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section."

PROBLEM 174

Illustrating Evasion of Surtaxes by Incorporation

FACTS:

Henry Smith was the father of twin boys five years old. In order to provide a fund for them at 30 years of age, he conceived the idea of forming a corporation with a perpetual life which would not distribute any earnings during the first 25 years, but would accumulate these earnings and reinvest them in securities, thereby compounding the earnings. Accordingly he caused the Smith Investment Corporation to be organized in 1921. Its capital stock of $1,000,000 was issued in the names of his two sons, for securities of the value of $1,000,000 turned in to the corporation by Mr. Smith.

QUESTION I:

Since by the charter of the corporation it cannot distribute

any dividends for 25 years after organization, how would such a corporation be likely to be considered by the Bureau of Internal Revenue?

ANSWER:

The corporation would probably be considered one formed and availed of for the purpose of preventing the imposition of the surtax on its stockholders or members, by permitting its gains and profits to accumulate instead of being distributed among its members or stockholders.

QUESTION II:

What would be the procedure of the Bureau in such a case?

ANSWER:

Before the tax can be assessed under section 220 in addition to that imposed by section 230, the Commisioner must certify that in his opinion such accumulation is unreasonable for the purposes of the business. Upon request of the Commissioner or any collector, the corporation is required to file a statement of its income, the names and addresses of each stockholder and the amounts that would be payable to them if such income were distributed.

There are two methods of taxing such a corporation: (1) A tax of 25% of the net income of the corporation may be assessed in addition to the income tax imposed by section 230; (2) if all the stockholders agree, the Commissioner may assess each stockholder on his distributive share in the same manner as members of a partnership are taxed, in lieu of all income, war-profits and excess-profits taxes.

REFERENCE:

Sec. 220: "That if any corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be

computed, collected and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties, as that tax: Provided, That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each."

PROBLEM 175

Illustrating Withholding of Tax—Income of Nonresident Aliens on Which Tax is to be Withheld at Source.

FACTS:

The Artemis Corporation, located at Baltimore, Maryland, acts as financial agent for various foreign individuals and interests. This company collects income accruing within the United States to the foreign principals, which have no residence here nor agents other than the Artemis Corporation.

QUESTION:

Must the Artemis Corporation withhold, for Federal Tax purposes, any of the income collected for the foreign principals? If so, what amount must be withheld?

ANSWER:

To the extent that such nonresident foreign principals consist of individuals or of partnerships composed in whole or in part

of nonresident alien individuals, the Artemis Corporation must withhold 8% of all annual or periodical gains, profits, and income of foreign principals, except on the following:

1. Dividends collected on the stock of domestic corporations not entitled to the benefits of section 262.
2. Dividends collected on the stock of foreign corporations more than 50% of whose gross income for the 3-year period ending with the close of its taxable year preceding the declaration of such dividends (or such part of such period as the corporation had been in existence) was derived from sources within the United States as determined under the provisions of section 217.
3. Interest received on tax-free covenant bonds.
4. Interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein.
5. Other income that may be specifically exempted under regulations to be prescribed by the Commissioner in connection with section 217.

In the case of tax-free covenant bonds only 2% of the interest upon such bonds is required to be withheld. This is withheld by the obligor.

REFERENCES:

Sec. 221 (a): "That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall (except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to eight per centum thereof: *Provided,* That

the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent."

Sec. 221 (b) (Quoted under following Problem).

PROBLEM 176

Illustrating Withholding of Tax—Interest Received on Tax-Free Covenant Bonds

FACTS:

The McCandless House Wrecking Company has outstanding 5% tax-free covenant bonds, the holders of which comprise non-resident alien individuals, individual citizens or residents of the United States, partnerships, and others whose status is unknown.

QUESTION:

What tax, if any, is required to be withheld by the McCandless Company on interest payments?

ANSWER:

Two percent must be withheld on all such payments to a non-resident alien individual or to an individual citizen or resident of the United States or to a partnership. The Commissioner may also authorize such withholding where the holder of the bonds is unknown to the obligor. Such withholding is not required in the case of a citizen or resident who files with the obligor before February 2, a signed notice in writing (form 1001 under the 1918 Act) claiming personal exemption covering such tax; nor will withholding be required in the case of a non-resident alien individual if regulations to be promulgated by the Commissioner under Section 217 (g) should so prescribe.

REFERENCE:

Sec. 221 (b): "In any case where bonds, mortgages, or deeds of trust, or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction

for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217."

PROBLEM 177

Illustrating the Reporting of and Payment of Tax Withheld at Source

FACTS:

The Iriquois Ink Company in 1921 withholds, in accordance with section 221 (a), 8% of the compensation of certain nonresident alien individuals in its employ.

QUESTION:

What disposition is to be made by the Iriquois Ink Company of the tax so withheld?

ANSWER:

A report must be filed not later than March 1, 1922, and the tax must be paid in to the Government not later than June 15th.

REFERENCE:

Sec. 221 (c): "Every individual, corporation, or partnership required to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby in-

demnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section."

PROBLEM 178

Illustrating Method of Reporting Income Received on Which Tax has been Withheld at the Source

FACTS:

Giuseppi Travoli, a nonresident alien, in 1921 receives salary for services performed within the United States on which tax has been withheld at the source.

QUESTION:

How is this income to be reported?

ANSWER:

The entire income upon which the tax has been withheld is to be included in the return of the recipient of the income, but the amount of tax withheld is to be credited against the tax as computed in such return.

REFERENCE:

Sec. 221 (d): "Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return."

PROBLEM 179

Illustrating Case in Which Tax is Paid by Nonresident Alien on Income Received upon which Tax had not been Withheld

FACTS:

Haaken Hansen, a nonresident alien, in 1920 receives certain income in the United States on which the tax has not been withheld at the source. Mr. Hansen reports the full income and pays the full tax thereon.

QUESTION:

Will the tax be re-collected from the withholding agent, and will penalties accrue because of this irregularity?

ANSWER:

The tax will not be re-collected from the withholding agent, and no penalties will accrue unless such irregularity was due to fraud and an attempt to evade payment of the tax.

REFERENCE:

Sec. 221 (e): "If any tax required under this section to be deducted and withheld is paid by the recipient of the income, it shall not be recollected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment."

PROBLEM 180

Illustrating Credit for Taxes Paid to a Possession of the United States by a Resident of the United States

FACTS:

J. Partola, a resident of the United States, one third of whose net income is received from sources within Porto Rico, the other two thirds being derived from sources within the United States, in the calendar year 1921 pays to Porto Rico an income tax amounting to $30. The firm, Partola and Partola, in which he has one-half interest, in the same year pays to Porto Rico income tax amounting to $40. Mr. Partola's total income-tax liability to the United States is $300.

QUESTION:

May any portion of the $30 paid by Mr. Partola or of the $40 paid by the firm of Partola and Partola be taken as a credit against his Federal income tax liability?

ANSWER:

Yes. He may apply as a credit the full $30 paid by himself

and his proportionate share (½) of the amount paid by the partnership in which he has one-half interest.

REFERENCES:

Sec. 222 (a): "That the tax computed under Part II[1] of this title shall be credited with: . . . (2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and . . . (4) In the case of any such individual who is a member of a partnership or a beneficiary of an estate or trust, his proportionate share of such taxes of the partnership of the estate of trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be."

PROBLEM 181

Illustrating Credit for Taxes Paid to a Foreign Country by An Alien Resident of the United States

FACTS:

A. Fiani, an alien resident of the United States, pays to Italy, of which country he is a citizen, an income tax of $50 in the calendar year 1921. One-fourth of his income is derived from sources within that country, and the balance is derived from sources within the United States. His Federal income tax liability is $400.

QUESTION 1:

Can Mr. Fiani credit his Federal income tax liability with the amount of income tax paid to the country of which he is a citizen?

ANSWER 1:

Yes, because Italy permits a similar credit to citizens of the United States resident in Italy.

REFERENCE:

Sec. 222 (a): "That the tax computed under Part II[1] of this title shall be credited with: . . . (3) In the case of an alien resident of the United States, the amount of any such taxes paid during the

[1] Relates to income tax on individuals.

taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country"; [see Art. 385, Reg. 62, for list of countries allowing similar credit to citizens of the United States].

QUESTION 2:

If, after filing his Federal income tax return and making claim for the credit of $50, Mr. Fiani receives from the Italian Government a refund of a portion of the amount paid to that country, is any further action to be taken by him with respect to his Federal tax status?

ANSWER 2:

Yes, he must notify the Commissioner of Internal Revenue, who will recompute Mr. Fiani's tax liability, and Mr. Fiani will be required to pay an additional tax.

REFERENCE:

Sec. 222 (b): "If accrued taxes when paid differ from the amounts claimed as credits by the taxpayer, or if any tax paid is refunded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II[1] of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer, in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require."

PROBLEM 182

Illustrating Limitation on Credit for Foreign Income Taxes Paid by a Citizen of the United States

FACTS:

G. Spinola, citizen of the United States, has a total taxable

[1] Relates to income tax on individuals.

net income in 1921 amounting to \$9,000 before making any deduction for foreign income taxes paid by him. Of this amount \$3,000 is derived from foreign sources, upon which he has paid foreign income taxes of \$500. His exemption is \$1,000. Mr. Spinola files his return on a calendar year basis.

QUESTION:

What portion of the \$500 foreign income tax paid may be taken as a credit against Mr. Spinola's Federal tax liability?

ANSWER:

Assuming the amount of the credit to be "C," then the amount deductible from income is \$500 minus C, and the taxable net income is \$9,000 minus (\$500 minus C), or \$8,500 plus C. Mr. Spinola's normal tax will be 4% of \$4,000 plus 8% of (\$8,500 plus C minus \$5,000). His total normal tax is therefore \$160 plus \$680 plus $\frac{8C}{100}$ minus \$400, or \$440 plus $\frac{8C}{100}$. His surtax will be \$50 plus 3% of (\$8,500 plus C minus \$8,000), a total of \$50 plus \$255 plus $\frac{3C}{100}$ minus \$240, or \$65 plus $\frac{3C}{100}$.

The total Federal tax liability is, therefore, \$440 plus $\frac{8C}{100}$ plus \$65 plus $\frac{3C}{100}$, a total of \$505 plus $\frac{11C}{100}$.

The credit will be $\frac{3000}{9000}$, or ⅓, of (\$505 plus $\frac{11C}{100}$).

Therefore C equals ⅓ (\$505 plus $\frac{11C}{100}$) = \$168⅓ plus $\frac{11C}{300}$

300 C equals \$505.00 plus 11C
289 C " 505.00
C " 174.74, the amount of the credit.

PROOF:

Net income before deducting foreign tax	\$9,000.00
Foreign tax deductible (\$500.00–\$174.74) ...	325.26
Taxable net income	\$8,674.74
Exemption	1,000.00

Income Tax:

$4,000 at 4%	$160.00
3,674.74 at 8%	293.98
Surtax: $50 plus 3% of $674.74	70.24
Federal tax liability	$524.22
Credit $\frac{3,000}{(9,000}$ or ⅓, of $524.22)	$174.74

REFERENCE:

Sec. 222 (a) "That the tax computed under Part II[1] of this title shall be credited with: . . . (1) In the case of a citizen of the United States the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and . . . (5) The above credits shall not be allowed in the case of a citizen entitled to the benefits of section 262; and in no other case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year."

NOTE:

See Problem 183 for comment. Under the facts assumed in this problem, the computation of the approximate credit would be as follows:

Tentative net income		$9,000.00
Exemption		1,000.00
Normal tax:		
$4,000 @ 4%	$160.00	
4,000 @ 8%	320.00	
Surtax:		
$50 plus 3% of $1,000	80.00	
Total tentative tax		$560.00
Tentative credit, $\frac{3,000}{9,000}$, or ⅓, of $560		$186.67

[1] Relates to income tax on individuals.

Net income before deducting tax		$9,000.00
Tax deductible ($500–$186.67)		313.33
Taxable net income		$8,686.67
Normal tax:		
4% of 4,000	$160.00	
8% of $3,686.67	294.93	
Surtax:		
$50 plus 3% of $686.67	70.60	
Federal tax liability		$525.53
Credit, ⅓ of $525.53		175.18

PROBLEM 183

Illustrating Credit for Foreign Income Taxes Paid by a Domestic Corporation—1921

FACTS:

The Acme Adding Machine Company, a domestic corporation in the calendar year 1921, pays foreign income and profits taxes amounting to $25,000, on income from foreign sources amounting to $50,000. The company's total taxable net income without deducting any amount for foreign income and profits taxes paid, was $150,000. Its invested capital for 1921 was $500,000. It files its returns on the calendar-year basis.

QUESTION:

What portion of the $25,000 income and profits taxes paid to the foreign country may be taken as a credit against the company's Federal income and profits tax liability for the calendar year 1921?

ANSWER:

Using the letter "C" to indicate the amount of credit that will be allowed, the net income subject to Federal income and profits tax will be $150,000 minus ($25,000 minus C), or $125,000 plus

C. If "X" indicates the excess-profits tax liability, the income tax liability of the corporation will be 10% of ($125,000 plus C minus X). In computing the excess-profits tax liability, the excess-profits credit will be $3,000 plus 8% of $500,000, a total of $43,000. The amount falling within the first bracket (subject to 20% tax) will be (20% of $500,000) minus $43,000, or $57,000, and the amount in the second bracket (subject to 40% tax) will be the total income less $100,000, or $25,000 plus C. The excess-profits tax will then be

20% of $57,000
plus 40% of ($25,000 plus C)

X, the excess-profits tax, therefore = $11,400 plus $10,000 plus 40% of C, or $21,400 plus $\frac{2C}{5}$ The normal tax is 10% of ($125,000 plus C minus X), or 10% of ($125,000 plus C minus $21,400 minus $\frac{2C}{5}$), or 10% of ($103,600 plus $\frac{3C}{5}$ or $10,360 plus $\frac{50}{3C}$

The total tax is therefore $21,400 plus $\frac{2C}{5}$ plus $10,360 plus $\frac{3C}{50}$, or $31,760 plus $\frac{23C}{50}$

The corporation's income from foreign sources was $50,000 and its entire net income (computed without deduction for any foreign income or profits taxes) was $150.000. The credit on account of foreign income and profits taxes, therefore, cannot exceed $\frac{50.000}{150,000}$, or ⅓, of the Federal tax liability ($31,760 plus $\frac{23C}{50}$). C, therefore, = ⅓ of ($31,760 plus $\frac{23C}{50}$), or $10,586.67 plus $\frac{23C}{150}$

Therefore, $\frac{127C}{150}$ = $10,586.67.

C, the credit to be applied against the Federal tax, = $12,503.94.

PROOF:

Net income before deducting foreign tax ..	$150,000.00
Foreign tax not used as credit ($25,000–$12,503.94)	12,496.06
Taxable net income	$137,503.94

Surtax:

Bracket	Net income	Exemption	Balance	Rate	Tax
1.	$100,000.00	$43,000.00	$57,000.00	20%	$11,400.00
2.	37,503.94	—0—	37,503.94	40%	15,001.58
	$137,503.94	$43,000.00	$94,503.94		$26,401.58

		Tax
Net income	$137,503.94	
Excess-profits tax	26,401.58	$26,401.58
Taxable at 10%	$111,102.36	11,110.24
Total tax		$37,511.82

One-third of this amount equals $12,503.94, the credit shown above.

Reference:

Sec. 238: "(a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: Provided, That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to its entire net income (computed without such deduction) for the same taxable year. . . . (b) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the income, war-profits and excess-profits taxes for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be

paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satisfactory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require."

NOTE:

Although the above computation shows the exact amount of the credit, it is quite probable that in actual practice the computation used will be considerably less complicated, and will be designed to arrive at a result which is only approximately correct. That the Bureau has not insisted on exact results in cases which in order to arrive at such results would require the use of algebraic formulae is indicated by the method prescribed in Regulations 45, Art. 857 for arriving at net income available for distribution in dividends for the purpose of computing invested capital when the amount distributed from current available income and the accrued tax liability are each indeterminate because the computation of one depends upon the other. Where only a portion of the income and profits taxes paid to a foreign country is to be allowed as a credit, the balance being deductible from taxable net income and thereby affecting the Federal tax liability which in turn affects the amount of the credit and of the deduction, there arises a similar situation.

The following is submitted as a method of arriving at the approximate amount of the credit under the conditions set forth under "Facts" above:

Invested capital	$500,000
Net income	150,000

Bracket	Income	Exemption	Balance	Rate	Excess-profits Tax
1.	$100,000	$43,000	$57,000	20%	$11,400
2.	50,000	—0—	50,000	40%	20,000
	$150,000	$43,000	$107,000		$31,400

		Tax
Net income	$150,000	
Excess-profits tax	31,400	$31,400
Taxable at 10%	$118,600	11,860
Total tentative tax		$43,260

$\frac{50,000}{150,000}$ or ⅓, of $43,260 equals $14,420, tentative credit.

$25,000 less $14,420 equals $10,580, the amount to be deducted from $150,000 to arrive at the taxable net income.

$150,000 minus $10,580 equals $139,420.

Bracket	Income	Exemption	Balance	Rate	Tax
1.	$100,000	$43,000	$57,000	20%	$11,400
2.	39,420	—0—	39,420	40%	15,768
	$139,420	$43,000	$96,420		$27,168

		Tax
Net income	$139,420	
Excess-profits tax	27,168	$27,168.00
Taxable at 10%	$112,252	11,225.20
Tax liability		$38,393.20
Credit allowed, ⅓ of above		$12,797.73

PROBLEM 184

Illustrating Credit for Foreign Income Taxes Paid by a Domestic Corporation—1922

FACTS:

The Bogota Building Company, a domestic corporation reporting on the calendar year basis, in 1922 pays foreign income and profit-taxes amounting to $10,000 on income from foreign

sources amounting to $40,000. Tht company's total taxable net income without deducting any amount for foreign income and profits taxes paid, was $200,000.

QUESTION:

What portion of the $10,000 foreign income and profits taxes paid may be taken as a credit against the company's Federal tax liability?

ANSWER:

Let C = the amount of the credit.

Then $10,000 minus C = deduction from income, and $200,000 minus ($10,000 minus C) or $190,000 plus C = taxable net income.

The Federal tax on this amount is 12½% of ($190,000 plus C).

The maximum amount allowable as a credit is $\frac{40{,}000}{200{,}000}$ of 12½% of ($190,000 plus C), which is $4,750 plus $\frac{C}{40}$

$$C = \$4{,}750 \text{ plus } \frac{C}{40}$$

$$\frac{39C}{40} = \$4{,}750$$

$$C = \$4{,}871.79$$

PROOF:

Net income before taking out deductible portion of foreign tax paid:	$200,000.00
Foreign tax deductible ($10,000 less $4,871.79)	5,128.21
Taxable net income	$194,871.79
Tax at 12½% (⅛ of $194,871.79)	$ 24,358.97
Credit for foreign taxes ($\frac{40{,}000}{200{,}000}$ or ⅕, of $24,358.97)	$ 4,871.79

NOTE:

See reference and comment under preceding problem. Under the circumstances assumed as "facts" in this problem, the computation of the approximate credit would be as follows:

Net income	$200,000
Tentative tax at 12½%	25,000
Tentative credit ($\frac{40,000}{200,000}$ or ⅕, of $25,000)	5,000
Deduction from income ($10,000 less $5,000)	5,000
Taxable net income ($200,000 less $5,000)	195,000
Tax at 12½%	24,375
Credit ($\frac{40,000}{200,000}$ or ⅕, of $24,375)	4,875

PROBLEM 185

Illustrating the Computation of the Credits Allowed a Domestic Corporation Owning a Majority of the Voting Stock of a Foreign Corporation From Which it Receives Dividends (Not Deductible Under Sec. 234) From Profits on Which the Distributing Company Has Paid Foreign Income and Profits Taxes

FACTS:

The Tupper Metal Co., Inc., a domestic corporation, owns 80% of the stock (all of one class) of the Bellaire Iron Works, a foreign corporation, which during the five years preceding December 31, 1921, has derived all its income from foreign sources. The net income of the Tupper Metal Company for its accounting year ended December 31, 1921, is shown in the following:

Dividend from Bellaire Iron Works	$100,000
Net income from operations	100,000
Total net income	$200,000

The Federal income and profits tax liability of the Tupper Metal Company, Inc., on the above income, before taking any credit for any part of the foreign income and profits taxes paid by the Bellaire Iron Works, was $60,000.

The net income of the Bellaire Iron Works for the calendar year 1920 (before deducting income and profits taxes of $40,000 accrued for 1920) was $200,000. The company paid a dividend of $125,000 February 1, 1921 (its only dividend in 1921), of which amount the Tupper Metal Company received 80%, or $100,000, as shown above.

QUESTION:

What amount of credit will be allowed the Tupper Metal Company against its own income and profits taxes, for income and profits taxes accrued against the Bellaire Iron Works?

ANSWER:

The above dividend, having been paid in the first sixty days of the 1921 accounting year, is regarded as having been paid from the 'accumulated profits' of 1920 (such being the most recently accumulated earnings, sufficient to meet the dividend paid February 1, 1921, of the year or years preceding 1921). The 'accumulated profits' of the Bellaire Iron Works for 1920, is the excess of the net income for that year ($200,000) over the income and profits taxes on that income ($40,000), or $160,000.

As the income and profits taxes of $40,000 are due by the Bellaire Iron Works with respect to the total net income of $200,000 for 1920, the tax applicable to, or with respect to, the 'accumulated profits' may be taken to be that proportion of the total tax which the 'accumulated profits' bears to the total net income, or four-fifths of $40,000, which is $32,000.

The dividend received by the Tupper Metal Company from the Bellaire Iron Works, $100,000, is to the 'accumulated profits' out of which the dividend was paid, $160,000, as 5:8. Five-eighths of $32,000 is $20,000, which amount is the credit allowed the Tupper Metal Company against its own income and profits taxes of $60,000.

It must be observed that the $20,000 credit is less than the maximum limit upon such credit allowed by the statute. The maximum limitation is that proportion of the tax against which credit is claimed ($60,000 in this case) which the amount of dividends received from the foreign corporation on account of which credit is claimed ($100,000 in this case) bears to the entire net income in which such dividends are included (in this case $200,000). In this case the maximum limit is one-half of $60,000, or $30,000.

The credit to be allowed is $20,000.

REFERENCE:

Sec. 238: "(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided,* That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation."

PROBLEM 186

Illustrating Requirements to be met Before Commissioner will Allow Credit on Account of Foreign Income Taxes Paid

FACTS:

Walter B. Ames is a citizen of the United States having income from foreign sources as well as from sources within the United States. In 1921, he paid income tax to a foreign government. He is desirous of knowing what steps are necessary for him to take in order to credit his United States income tax with the allowable portion of the foreign income tax (as computed under section 222 (a) (1) and (5), (for illustration see Problem 182).

QUESTION:

What conditions are precedent to the allowance of a credit of foreign income tax against the income tax due the United States?

ANSWER:

It will be necessary for Mr. Ames to furnish the Commissioner with such information as will enable him to verify the correctness of the computation of the credit. In 1920 the Bureau prepared form 1116 on which the necessary information could be given. It is probable that a similar form will be issued in 1922, indicating the information required.

REFERENCE:

Sec. 222 (c): "These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits."

CORPORATIONS:

Corporations are also required to furnish the Commissioner such information as is required from individuals, the form for corporations during 1920 being 1118 instead of 1116 as above.

Sec. 238 (c): "These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credit."

PROBLEM 187

Illustrating Computation of Credit for Income Taxes Paid to Foreign Government or Possession of United States in Case Taxpayer Files Return for Fiscal Year Ending in 1921

FACTS:

Hiram Wheeler, a citizen of the United States, is about to file his income tax return for the twelve month period ending September 30, 1921. He finds upon an examination of his accounts that he paid to the Dominion of Canada during this period, income taxes in the amount of $490. One-third of his gross income and of his net income was derived from sources within the Dominion of Canada and two-thirds from sources within the United States. Mr. Wheeler finds that his United States income tax liability for the fiscal year ended September 30, 1921, without taking as a deduction from gross income any part of the income tax paid to the Dominion of Canada above mentioned, amounts to $2,465.

QUESTION:

If Mr. Wheeler should undertake to apply the amount of the income tax paid to the Dominion of Canada as a credit against the income tax due the United States, will such treatment be allowed by the Bureau?

ANSWER:

The Bureau will allow as a credit only such part of the income taxes paid to the Dominion of Canada, which is not in excess of the limits prescribed in paragraph 5 of section 222 (a). In other words such a credit shall not exceed "the same proportion of the tax, against which such credit is taken, which the tax-

payer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year." This limitation is made despite the fact that part of the income of Mr. Wheeler was derived in 1920 and part in 1921, because of the specific requirements to this effect set forth in paragraph (d) of section 222 which is quoted below in reference. If it were not for this specific provision of said paragraph (d) it might be logical to expect that that portion of the full income taxes paid to the Dominion of Canada applicable to 1920, would be credited in full against United States income taxes due for 1920, in accordance with the provisions of the Revenue Act of 1918.

REFERENCE:

Sec. 222, (d): "If the taxpayer makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer."

NOTE:

The credit referred to in the quotation above given is the credit on account of income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States more fully set forth in paragraph (a) of section 222. If the taxpayer is a corporation the following reference applies:

Sec. 238 (d): "If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer."

PROBLEM 188

Illustrating Case in Which Individual is Required to File a Return—Net Income more than $1,000

FACTS:

Stephen H. Brown, a real estate broker made $1,800 net in-

come in the real estate business during the taxable year 1921. He had been living with his wife and child in an apartment up to the time of the death of his wife on December 26, 1921, but shortly thereafter (December 29, 1921,) he gave up the apartment, placed the child in an orphan asylum and rented a room in a boarding house. He had always filed his returns on the the calendar year 1921.

QUESTION:

Will Mr. Brown be required to file an income tax return for the calendar year 1921?

ANSWER:

Yes. As Mr. Brown's wife died prior to the close of his taxable year, his status at December 31, 1921 is that of a single man. As his income was in excess of $1,000, he must file a return.

REFERENCE:

Sec. 223 (a): "That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife; . . ."

PROBLEM 189

Illustrating Case in which Individual is not Required to File a Return

FACTS:

Mr. Harold A. Barton, a bachelor, was employed as a bookkeeper at a salary of two thousand dollars during the year 1921. In addition to his salary his income consisted of forty dollars interest from Liberty Bonds and $1,200 rent from two dwelling houses which he owns. One of the dwelling houses burned down during 1921 resulting in a loss of $2,000, not compensated by insurance. His expenses for taxes, repairs to dwellings, etc., amounted to $340 for the taxable year.

QUESTION:

Will Mr. Barton be required to file an income tax return for the taxable year 1921?

ANSWER:

Mr. Barton will not be required to file a return for the taxable year 1921, as his gross income is less than $5,000 and his net income is less than $1,000.

Salary		$2,000
Income from rent		1,200
Gross income		$3,200
Less:		
Loss on dwelling destroyed by fire	$2,000	
Taxes, repairs etc.	340	2,340
Net income		$860

NOTE:

The Liberty Bond interest is exempt from taxation.

REFERENCE:

Section 223 (a): "That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife; . . . (3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income."

PROBLEM 190

Illustrating a Case in Which Individual is Required to File an Income Tax Return, even though there is no Tax Due thereon—Individual Having Net Income of $2,000 or over, if Married and Living with Husband or Wife

FACTS:

Mr. Howard A. Jerome is married and was living with his

wife on December 31, 1921, the last day of his taxable year. He has a ten year old son entirely dependent upon him. Mr. Jerome received a salary of $2,800 for the taxable year 1921. Mrs. Jerome received no income whatsoever during the year 1921.

QUESTION:

Will Mr. Jerome be required to file an income tax return for the taxable year 1921?

ANSWER:

Yes, Mr. Jerome will be required to file an income tax return for the taxable year 1921, as his net income was in excess of $2,000, for the above period. However, he will not be required to pay any tax as he is entitled to a personal exemption of $2,500 due to the fact that his net income together with his wife's net income is less than $5,000 and he is entitled to a credit of $400 for his dependent child, making a total exemption of $2,900, which is in excess of his total taxable income.

REFERENCES:

Section 223 (a): "That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title. . . . (2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife. . . ."

Section 216: "That for the purpose of the normal tax only there shall be allowed . . . (c) In the case of a single person, a personal exemption of $1,000; or in the case of the head of a family or a married person living with husband or wife, a personal exemption of $2,500, unless the net income is in excess of $5,000, in which case the personal exemption shall be $2,000. A husband and wife living together shall receive but one personal exemption. The amount of such personal exemption shall be $2,500, unless the aggregate net income of such husband and wife is in excess of $5,000, in which case the amount of such personal exemption shall be $2,000. If such husband and wife make separate returns the personal exemption may be taken by either or divided between them. In no case shall the reduction of the personal exemption from $2,500 to $2,000 operate to increase the tax, which would be payable if the exemption were $2,500, by more than the amount of the net income in excess of $5,000;

(d) $400 for each person (other than husband or wife)dependent

upon and receiving his chief support from the taxpayer if such dependent is under eighteen years of age or is incapable of self-support because mentally or physically defective."

PROBLEM 191

Illustrating Case in Which Husband and Wife File Joint Return Although Aggregate Net Income is Less Than Exemption

FACTS:

Walter S. Cooper operated a grocery store and during the calendar year 1921 made a gross profit of $10,000 and a net profit of $6,000. His wife, Mary A. Cooper, who was living with her husband, received no income during the calendar year 1921, but sustained a loss of $5,000 as the result of the theft of all her jewelry which was not covered by insurance. Mr. Cooper in previous years has filed a single return on a calendar-year basis, including therein his wife's income.

QUESTION:

Will Mr. Cooper be required to file a return for the calendar year 1921?

ANSWER:

Mr. Cooper will be required to file either a return including merely his own income therein or a joint return including the aggregate income and deductions of his wife and himself as in either case the gross income to be reported is in excess of $5,000.

It would be more advantageous for Mr. Cooper to file a joint return with his wife rather than a separate return as the aggregate net income under a joint return is less than the $2,000 exemption allowed under section 216 (c) of the Revenue Act of 1921, and no tax would be due; whereas, if Mr. Cooper files a separate return, he will have $6,000 taxable income.

REFERENCE:

Sec. 223: "(a) That the following individuals shall each make under oath a return stating specifically the items of his gross income

and the deductions and credits allowed under this title. . . . (3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income. (b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over, . . . (2) the income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income."

PROBLEM 192

Illustrating Case in Which Individual is Unable to make His Own Return

FACTS:

Allan Jordan, whose parents are dead, is an infant seven years of age. He receives an income of $25,000 annually from property, which income is turned over to his duly appointed guardian, James Warren, for the support, maintenance, etc., of the ward.

QUESTION:

Will Allan Jordan be required to file an income-tax return for the calendar year 1921?

ANSWER:

The ward being an infant, and unable to make his own return, Mr. Warren, his guardian, should file a return for him.

REFERENCE:

Sec. 223. (c): "If the taxpayer is unable to make his own return, the returns shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer."

PROBLEM 193

Liability for Filing Return—Partnership

FACTS:

The Mails & Mails Company, a partnership, keeps its books on the calendar-year basis.

QUESTION:

Is the partnership required to file a return for 1921?

ANSWER:

Yes, however for information purposes only. A return sworn to by any one of the partners must be filed for each taxable year.

REFERENCE:

Section 224: "That every partnership shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed and the amount of the distributive share of each individual. The return shall be sworn to by any one of the partners."

PROBLEM 194

Liability for Filing Return—Fiduciary

FACTS:

John Morgan acts in a fiduciary capacity for individuals, estates, and trusts.

QUESTION:

Is Mr. Morgan required to file returns for the individuals, estates, and trusts for which he acts?

ANSWER:

Mr. Morgan must make a return of income (a) for each individual whose income is in his charge, if the net income of such individual is $2,000 or over if married and living with husband or wife or is $1,000 or over in other cases, (b) for each trust and estate for which he acts, if the net income of such trust or estate is $1,000 or over or if any beneficiary of such trust or estate is a nonresident alien, and (c) every individual, whose income is in his charge, having a gross income for the taxable year of $5,000 or over, regardless of the amount of the net income.

REFERENCE:

Sec. 225 (a): "That every fiduciary (except a receiver appointed

by authority of law in possession of part only of the property of an individual) shall make under oath a return for any of the following individuals, estates, or trusts for which he acts, stating specifically the items of gross income thereof and the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

(2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife;

(3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income;

(4) Every estate or trust the net income of which for the taxable year is $1,000 or over, and

(5) Every estate or trust of which any beneficiary is a nonresident alien."

PROBLEM 195

Liability for Filing Return—Joint Fiduciaries

FACTS:

J. Miller, S. Brown and L. Jones, are joint fiduciaries for an individual, for whom it is necessary to make a return.

QUESTION:

Who should make the above return?

ANSWER:

Any one of the three fiduciaries, who knows enough about the individual's affairs to make the return.

REFERENCE:

Sec. 225 (b): "Under such regulations as the Commissioner with the approval of the Secretary may prescribe a return by one of two or more joint fiduciaries and filed in the office of the collector of the district where such fiduciary resides shall be sufficient compliance with the above requirement. Such fiduciary shall make oath (1) that he has sufficient knowledge of the affairs of the individual, estate or trust for which the return is made, to enable him to make the return, and (2) that the return is, to the best of his knowledge and belief, true and correct. Any fiduciary required to make a return under this Act shall be subject to all the provisions of this Act which apply to individuals."

PROBLEM 196

Illustrating Computation of Tax on Return for Period of Less Than Twelve Months

FACTS:

S. Bolden, a citizen of the United States, with the consent of the Commissioner changed his accounting period from the fiscal year ended June 30, 1921 to the calendar-basis year. Accordingly he is required to file a return for the period from July 1, 1921 to December 31, 1921. He has a net income of $30,000 for this period. He is married and was living with his wife on December 31, 1921.

PROBLEM:

Show the computaton of Mr. Bolden's income tax.

SOLUTION:

Net income for 6 months (July 1 to December 31, 1921)	$30,000
Net income on annual basis $\frac{(12 \times \$30,000)}{6}$	$60,000
Less: Personal exemption	2,000
Balance	$58,000
Tax at 4% (on $ 4,000)	$ 160
" " 8% (on 54,000)	4,320
Surtax on $60,000 at 1921 rates	8,110
Total tax (on annual basis)	$12,590
Tax assessable for 6 months ($\frac{6}{12}$ of $12,590)	$ 6,295

REFERENCES:

Sec. 226 (c): "In the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of

months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months."

For further illustration see Art. 431, Reg. 62.

PROBLEM 197

Illustrating Rates of Tax Applying in Case a Return is Filed For a Period of Less Than Twelve Months—Period Falling Partly Within One Calendar Year and Partly Within Another Calendar Year

FACTS:

S. B. Lois made a return for the eight-months period from July 1, 1921, to February 28, 1922, on account of having changed his accounts, with the approval of the Commissioner, from the basis of a fiscal year ending June 30 to the basis of a fiscal year ending February 28. His taxable net income for the eight months was $60,000, and his exemption (for a full year) was $2,400.

QUESTION:

What is Mr. Lois' tax liability for the eight-months period?

ANSWER:

In accordance with the provisions of section 226 (c) the net income must first be placed on an annual basis by multiplying by twelve and dividing the result by the number of months in the period. The tax must then be computed on this 'annual' income (equivalent to a fiscal year) according to the method prescribed in section 205 (b) for fiscal years ended in 1922, and the total resultant tax arrived at on this 'annual' basis must be reduced to the proportion which the number of months in the period (eight) is of twelve months.

The computation follows:

Net income for eight months $60,000
" " " twelve " at

same rate ($\frac{12}{8}$ × $60,000)	$90,000	
Exemption	2,400	
Balance subject to normal tax ...	$87,600	Tax
Tax at 4% (on $ 4,000)		$ 160.00
" " 8% (" 83,600)		6,688.00
Surtax on $90,000 at 1921 rates ..	$18,910	
$\frac{6}{8}$ of $18,910 (for proportionate part of period falling in calendar year 1921)		14,182.50
Surtax on $90,000 at 1922 rates ..	$17,960	
$\frac{2}{8}$ of $17,960 (for proportionate part of period falling in calendar year 1922)		4,490.00
Total tax on basis of 12 months		$25,520.50
Tax for 8–months period ($\frac{8}{12}$ of $25,520.50)		$17,013.67

REFERENCES:
Sec. 226 (c): (Quoted under Problem 196)
Sec. 205 (b): (Quoted under Problem 43)

PROBLEM 198

Illustrating Time and Place for Filing Returns of Individuals, Partnerships, Fiduciaries, and Corporations

FACTS:

Georges Cartier, a nonresident alien, has income from sources within the United States. He keeps his accounts on a fiscal year basis ending July 31. He has no legal residence or principal place of business in the United States.

QUESTION:

What is the latest date on which Mr. Cartier must file his United States income tax return for his fiscal year ended July 31, 1921? Where should his return be filed?

ANSWER:

Mr Cartier's return should be filed not later than January 15, 1922 with the Collector of Internal Revenue at Baltimore, Md. The following table is appended to show the latest dates on which taxpayers may file their returns:

Fiscal year ends	Nonresident aliens; foreign corporations	All others
January 31	July 15	April 15
February 28	August 15	May 15
March 31	September ... 15	June 15
April 30	October 15	July 15
May 31	November 15	August 15
June 30	December 15	September ... 15
July 31	January 15	October 15
August 31	February 15	November 15
September ... 30	March 15	December 15
October 31	April 15	January 15
November 30	May 15	February 15
December 31	June 15	March 15

Whenever in his opinion there is sufficient cause for requesting a reasonable extension, the Commissioner may grant an extension of not over six months, except in the case of taxpayers abroad.

Returns are to be made to the Collector for the district in which the individual has his legal residence or principal place of business in the United States or in the case of a corporation to the collector for the district in which is located the principal office, agency or place of business in the United States. Where the taxpayer has no legal residence or principal place of business in the United States, the return is to be made to the collector at Baltimore, Maryland.

References:

Sec. 227: "(a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad no such extension shall be for more than six months.

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland."

Sec. 241: "(a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

"(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland."

PROBLEM 199

Illustrating Time for Paying Tax Installments in the Case of Corporation Reporting on a Fiscal-Year Basis

Facts:

The Carson Carpet Manufacturing Company, incorporated under the laws of the State of New York, closes its books on September 30th each year and reports its taxable income on such fiscal year basis. For the past two years the company has paid its Federal taxes in four equal installments.

Question:

When will the above company be required to pay its taxes for the fiscal year 1921?

ANSWER:

As the above company has established an accounting period for the twelve months ending on September 30, 1921, which is a fiscal year within the meaning of the statute, it should file a return on or before the fifteenth day of the third month, following the close of its fiscal year, or December 15, 1921. See Problem 198. The entire tax due by the company may be paid either in one sum at or before the time of filing the return or in four equal installments. If it chooses to pay its tax in installments, the first installment becomes due on the date fixed by law for filing the return, or December 15, 1921; the second installment becomes due on the fifteenth day of the third month after the time fixed by law for filing the return, or March 15, 1922; the third installment becomes due on the fifteenth day of the sixth month following date fixed for filing the return, or June 15, 1922; and the fourth installment becomes due on the fifteenth day of the ninth month following the date fixed for filing the return, or September 15, 1921.

REFERENCE:

Sec. 250 (a): "That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, and the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. . . . The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount shall be paid on or before the time fixed by law for filing the return. . . ."

PROBLEM 200

Illustrating Procedure to be Followed by a Taxpayer Upon Receipt from Collector of Notice of Understatement in His Return

FACTS:

Mr. Fred Smith, personally filed his return for the year 1921, at the office of the collector for his district. Subsequently

he received notice to show cause why the tax should not be increased, due to the inclusion on the return of certain expenses which the collector believed to be non-deductible.

QUESTION:

What recourse has Mr. Smith?

ANSWER:

He should immediately file sworn statements with the collector, setting forth the reasons for so reporting the facts, and other proofs if any, which may help to establish his contention. If the taxpayer is not satisfied with the conclusions of the collector, he has the privilege of appealing to the Commissioner for his decision.

REFERENCE:

Sec. 228: "That if the collector or deputy collector has reason to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary."

Art. 451, Reg. 45 Revised: "If a collector suspects that the amount of any income is understated in a return, he may on his own initiative take up the matter with the taxpayer and upon becoming satisfied that the amount was understated may increase it accordingly, subject to the right of the taxpayer to appeal to the Commissioner."

PROBLEM 201

Illustrating Computation of Tax in Case of Incorporation of Individual or Partnership within Four Months after November 23, 1921

FACTS:

John Dodge, conducting a machine shop during 1921 as an individual, with an invested capital of $500,000 as of January

1, 1921, incorporated December 31, 1921. The taxable net income for 1921 was $300,000. Mr. Dodge, a citizen of the United States, was unmarried and had no dependents on December 31, 1921. The market value of his business on June 30, 1921 was $1,000,000. Mr. Dodge had no other source of income. He reports on the calendar-year basis.

QUESTION:

How shall Mr. Dodge make his return for 1921?

The taxpayer, having the option in this case of filing as an individual or as a corporation on the 1921 income, should make computations of the tax he would have to pay if he chooses to report as an individual, and of what he would be required to pay if he chooses to report as a corporation. The return showing the lower tax may be filed. In this case as an individual the computation would be:

Net income	$300,000
Exemption	1,000
Balance	$299,000
Normal tax at 4% (on $ 4,000)	$ 160
" " " 8% (on $295,000)	23,600
Surtax	137,510
Tax assessable as an individual	$161,270

As a corporation the computation of the tax would be:

Net income	$300,000
Invested capital	500,000
Excess-profits tax	91,400
Income tax of 10%	20,860
Total income and profits tax assessable as a corporation	$112,260

Capital stock tax to be paid	995
Total tax due as a corporation	$113,255

The above computations show that the tax as a corporation is less than the tax as an individual. It must be borne in mind, however, if the return is made as a corporation, that Mr. Dodge would be subject, as an individual, to surtax on all dividends received from the corporation from earnings accumulated after December 31, 1920.

REFERENCE:

Sec. 229: "That in the case of the organization as a corporation within four months after the passage of this Act of any trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: Provided, That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year; Provided, further, That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921."

NOTE:

Sec. 1000 imposes the Federal Capital Stock tax.

PROBLEM 202

Illustrating Computation of Normal Tax on Corporations, 1921 and 1922

FACTS:

The Flower Cotton Company is a domestic corporation and reports on the calendar year basis. For 1921 the amount of its net income in excess of the credits provided in Section 236 is $50,000. For 1922 such excess is $60,000.

PROBLEM:

Compute the normal tax for the two years.

ANSWER:

1921	$50,000 × 10 per centum = ...	$5,000
1922	$60,000 × 12½ " " = ...	$7,500

The normal tax is, therefore, $5,000 for the calendar year 1921, and $7,500 for the calendar year 1922.

REFERENCE:

Sec. 230: "That in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount."

PROBLEM 203

Illustrating Corporations Exempt From Taxation—Labor, Agricultural or Horticultural Organizations

FACTS:

The Holstein Register Association of New York was organized by men interested in the breeding of Holstein cattle, to register the pedigree of such animals, and by arousing the interest of

farmers in such cattle induce them to raise better stock by introducing Holstein cattle into their herds for breeding purposes. Its income consists of registration fees and dues of members and is expended entirely for the purpose for which the association was formed.

QUESTION:

Is the association exempt from taxation?

ANSWER:

Yes, because the organization is an agricultural organization formed for the purpose of benefiting the breeders of the Holstein cattle so registered and the profits were solely used for such purpose.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— (1) Labor, agricultural, or horticultural organizations;"

PROBLEM 204

Illustrating Corporations Exempt from Taxation—Mutual Savings Banks Not Having a Capital Stock Represented by Shares

FACTS:

The New Idea Gas Light Mutual Savings Association was formed for the purpose of enabling the employees of the New Idea Gas Light Company, to save and borrow money. It was limited to the employees of the company, who elected a board of trustees to manage its affairs. Each member was allowed to subscribe to a certain number of shares, and could borrow to a certain amount. The profits, if any, were to be returned to the members in proportion to the number of shares held by each.

QUESTION:

Is the association exempt from the Federal income and profits tax for 1921?

ANSWER:

Yes. It has been held that the shares of stock sold by the association are merely the means to assist the members in accumulating their savings and that they do not constitute capital stock within the accepted business meaning of that term.

The dividends paid thereon are in reality interest on deposits.

REFERENCES:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— . . . (2) Mutual savings banks not having a capital stock represented by shares;"

Bul. 43-20-1265; O. D. 703: "An association of the employees of the N Company was formed for the purpose of enabling its members to save and borrow money. The members, who are limited to the employees of the N Company, elect annually a board of trustees to manage their affairs. Each member may subscribe to from 1 to 25 shares of stock, which is represented by certificates of deposit. At the end of the year the money paid in, together with the earnings thereon, is returnable to the members in proportion to the amount each has paid in, but each member has the option of allowing the money to remain on deposit where it accumulates further earnings. Any member may borrow from the association on his promissory note, at rates of interest ranging from 5 to 12 per cent, but in no greater amount than the amount remaining to his credit, plus a sum equal to one month's salary, unless the same is secured by satisfactory collateral. Held, that the shares of stock sold by the association are merely the means to assist the members in accumulating their savings and that they do not constitute capital stock within the accepted business meaning of that term. The dividends paid thereon are in reality interest on deposits (see 28 Op. A. G. 189; 31 id. 176); and the association is exempt under section 231 (2) of the Revenue Act of 1918 as a mutual savings bank not having a capital stock represented by shares."

PROBLEM 205

Illustrating Corporations Exempt from Taxation—Fraternal Beneficiary Societies, Orders or Associations

FACTS:

The Sunshine Mutual Aid Society was organized by members of a certain fraternal organization operating under the lodge system for the purpose of providing insurance exclusively to the members of the fraternal organization, for the benefit of their

dependents. Any member of the lodge who passes a satisfactory medical examination is eligible.

QUESTION:

Is this society exempt from taxation?

ANSWER:

Yes, because it is operated for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and provides for the payment of benefits to the dependents of such members.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— . . . (3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents;"

PROBLEM 206

Illustrating Corporations Exempt from Taxation—Domestic Building and Loan Associations

FACTS:

The Essex Building and Loan Association of New Jersey was organized under the laws of that state for the purpose of loaning money to its members in order that they might build their own homes. It later developed that the various installments were insufficient to meet the demands on the treasury of the association so that it was decided to issue full-paid certificates at a certain rate in order to have available funds to meet the demands of its members. All the members shared in the profits of the association on an equal basis.

QUESTION:

Is the association exempt from taxation?

ANSWER:

Yes, because it meets the test outlined in Art. 515, Reg. 62.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— . . . (4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and co-operative banks without capital stock organized and operated for mutual purposes and without profit;"

Art. 515; Reg. 62: "In general, a building and loan association entitled to exemption is one organized pursuant to the laws of any State, Territory, or the District of Columbia, which accumulates funds to be loaned primarily to its shareholders for the purpose of building or acquiring homes. In order to be exempt the association (1) must be mutual, that is, all of its stockholders or members must share in the profits on substantially the same footing; and (2) must be operated so that substantially all of its business is confined to the making of loans to bona fide shareholders . . ."

Bul. 48–20–1325, Sol. Op. 78: ". . . The test for exemption on these lines should be drawn on the line of whether the Association loans its funds in the manner of the typical building and loan association, that is, primarily for the purpose of home building and acquiring, or whether it invests its funds in the manner ordinarily done by banks and similar investment institutions. That is to say, a building and loan association which invests its funds primarily in loans for the building and acquiring of homes should not be deprived of exemption because, in order to raise funds from which to make these loans, it has become necessary to issue prepaid stock in amounts greatly outnumbering the installment stock. . . ."

PROBLEM 207

Illustrating Corporations Exempt from Taxation—Cemetery Companies

FACTS:

The Sea Cliff Cemetery Company was organized under the laws of the State of New York for the purpose of buying and managing a cemetery. Its charter provided that all lot owners were members of the company by reason of such ownership. In order to finance the project preferred stock was issued to the members who organized the company on which a semi-annual dividend of 6% was to be paid. The charter further provided that the stock was to be redeemed at par as soon as the proceeds

from the sale of lots would permit. All sums received in excess of the requirements to redeem the preferred stock was to be used exclusively for the management, care and beautification of the property.

QUESTION:

Is the company exempt from taxation?

ANSWER:

Yes.

REFERENCES:

Sec. 231: "That the following organizations shall be exempt from taxation under this title: . . . (5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual;"

Art. 516: "A cemetery company in order to be exempt must be owned and operated exclusively for the benefit of its lot owners or must not be operated for profit. Any cemetery corporation chartered solely for burial purposes and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual, is exempt from income tax. A cemetery company of which all lot owners are members, issuing preferred stock entitling the holder to a semiannual dividend of four per cent, and whose articles of incorporation provide that the preferred stock shall be retired at par as soon as sufficient funds are realized from sales and that all funds realized in addition thereto shall be used by the company for the care and improvement of the cemetery property, is within the exemption."

PROBLEM 208

Illustrating Corporations Exempt from Taxation—Religious, Charitable, etc., Organizations

FACTS:

The East Side Day Nursery was organized for the purpose of establishing and maintaining a day nursery for young children whose parents are obliged to work and have no means to provide

care for their children during the day. Its income is derived from subscriptions and donations and a small amount from securities, all of which is used in promoting the activities of the nursery. It is operated exclusively for that purpose and no part of its income inures to the benefit of private stockholders or individuals.

QUESTION:

Is the association exempt from taxation?

ANSWER:

Yes, because it was organized and is operated exclusively for charitable purposes.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— . . . (6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual;"

PROBLEM 209

Illustrating Corporations Exempt from Tax—Civic Leagues or Organizations Not Operated for Profit

FACTS:

The People's Forum is an association formed and supported by public-spirited men. The forum conducts meetings at which prominent speakers discuss important phases of civic and social welfare. The expenses of these meetings are met by contributions on the part of those interested in the work of the forum, the deficit, if any, being made up by the organizers.

QUESTION:

Is the People's Forum subject to tax?

ANSWER:

No.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title . . . (8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare;"

PROBLEM 210

Illustrating Corporations Exempt from Taxation—Clubs Organized for Pleasure, etc.

FACTS:

The Sunshine Club of Hartville was organized for the purpose of promoting the social welfare of its members. It derives its income from membership dues and donations which are used for the purpose of defraying expenses necessary to the operation and upkeep of its rooms, and no part of such dues or donations inures to the benefit of any of its members.

QUESTION:

Is the club exempt from taxation?

ANSWER:

Yes, because it meets with all the provisions of section 231 paragraph (9).

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title— . . . (9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member."

PROBLEM 211

Illustrating Corporations Exempt from Taxation—Mutual Benefit Companies Whose Entire Income Consists of Assessments Made for Sole Purpose of Meeting Expenses

FACTS:

The Nassau Insurance Company of New York was organized

for the purpose of permitting its members, all of whom are local automobile owners, to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks. The only source of income was from assessments, dues and fees collected from members for the sole purpose of meeting expenses.

QUESTION:

Is the association exempt from taxation?

ANSWER:

Yes.

REFERENCES:

Sec. 231: "The following organizations shall be exempt from taxation under this title— . . . (10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or co-operative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses;"

Bul. 25-19-586; O. D. 312: "An insurance association incorporated under the laws of a certain State for the purpose of permitting automobile owners to exchange contracts of insurance and indemnity without becoming jointly liable as subscribers on any risks, confining its activities within the State and its only source of income being from assessments, dues, and fees collected from members for the sole purpose of meeting expenses, is a 'like organization' within the meaning of section 231 of the Revenue Act of 1918 and is exempt from income taxes."

PROBLEM 212

Illustrating Corporations Exempt From Taxation—Farmers' and Fruit Growers' Associations

FACTS:

The Alhambra Fruit Growers' Association was organized for the purpose of assisting its members to market their fruit. The charter provided for the return to the members of the proceeds from the sales less the necessary selling expenses on the basis of

the quantity of fruit shipped by each member through the association.

QUESTION:

Is the association exempt from Federal income tax?

ANSWER:

Yes, as the corporation comes within the scope of Sec. 231 (11) referred to below:

REFERENCE:

Sec. 231: "The following organizations shall be exempt from taxation under this title . . . (11) Farmers', fruit growers', or like associations, organized and operated as sales agents for the purpose of marketing the products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;"

PROBLEM 213

Illustrating Corporations Exempt from Taxation—Corporations Organized to Hold Title to Property, the Income Being Turned Over to an Organization Which is Exempt from Taxation

FACTS:

The Church Investment Corporation was organized to hold title to certain property, in accordance with the terms of the will of Alfred Wardman, deceased. Its charter provided that the annual net income after paying operating expenses is to be turned over to the trustees of the First Church of Wellsville (a corporation organized and operated exclusively for religious purposes and no part of the net income of which inures to the benefit of any of its members).

QUESTION:

Is the Church Investment Corporation subject to income tax?

ANSWER:

No, because it meets the test of Sec. 231 (12).

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title . . . (12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;"

See Problem 208 for reference to exemption of religious organizations.

PROBLEM 214

Illustrating Corporations Exempt from Taxation—Federal Land Banks and National Farm Loan Associations

FACTS:

The Kansas City Bank, a joint-stock land bank created under the Federal Farm Loan Act of July 17, 1916, claims that it is exempt from the Federal income tax.

QUESTION:

Is this contention correct?

ANSWER:

No. Under the 1918 law no provision was made exempting joint-stock land banks, and the Revenue Act of 1921 also fails to say anything about such banks. Therefore they are liable to taxation and must file a return.

REFERENCE:

Sec. 231: "That the following organizations shall be exempt from taxation under this title . . . (13)—Federal land banks and national farm loan associations as provided in section 26 of the Act approved July 17, 1916, entitled 'An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes.'"

NOTE:

This quotation is exactly the same as section 231 (13) of the Revenue Act of 1918, which formed the basis for the opinion of the Solicitor (Bul. 41-20-1235; Sol. Op. 68) from which the following is quoted:

> " . . . Joint-stock land banks created under the Federal Farm Loan Act of July 17, 1916, are not exempt from the tax imposed on the net income of corporations by Title II of the Revenue Act of 1918. . . ."

PROBLEM 215

Illustrating Income to be Reported by Mutual Marine Insurance Companies

FACTS:

The L. M. N. Mutual Marine Insurance Company in 1921 collected and received gross premiums amounting to $300,000. In the same year the company paid $100,000 for reinsurance.

QUESTION:

How are the premiums received and the amounts paid for the reinsurance to be treated on the company's income-tax return?

ANSWER:

The premiums received are to be included in the gross income reported except that the amounts paid out for reinsurance should be eliminated—both from gross income and from deductions.

REFERENCE:

Sec. 233 (a): ". . . mutual marine insurance companies shall include in gross income the gross premiums collected and received by them less amounts paid for reinsurance."

PROBLEM 216

Illustrating Gross Income of Foreign Corporations

FACTS:

The Paris Post Corporation, a foreign corporation engaged in

the mail order business, has income from sources within the United States as well as from European countries.

QUESTION:

In filing its United States income tax return is the Paris Post Corporation required to include in its taxable net income the income received from sources other than the United States?

ANSWER:

The foreign corporation must include in its gross income only the income from sources within the United States.

REFERENCE:

Sec. 233 (b): "In the case of a foreign corporation, gross income means only gross income from sources within the United States, determined (except in the case of insurance companies subject to the tax imposed by section 243 or 246) in the manner provided in section 217."

See Problems 159 to 166, inclusive.

PROBLEM 217

Illustrating Deductions Allowed Corporations—Dividends Received

FACTS:

The Investment Securities Company, a domestic corporation, received the following dividends during its taxable year 1921, which it included in gross income under the provisions of section 233:

(1) $35,000 — common stock, Wakefield Foundry, Inc.
(2) 25,000 — preferred " , Hartsdale Chemical Co.
(3) 55,500 — common stock, Chile Export Co.
(4) 75,325 — " " , South American Film Co.

(1) and (2) are domestic corporations doing business solely in the United States; (3) a foreign corporation which has derived more than 75% of its gross income for each of the past five years from sales in the United States; (4) a foreign corporation having no income from sources within the United States.

QUESTION:

How should these dividends be treated on the Investment Securities Company's return for 1921?

ANSWER:

(1), (2) and (3) should be deducted from gross income; (4) is not deductible.

REFERENCE:

Sec. 234 (a): "That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions: . . . (6) The amount received as dividends (a) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (b) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such divdends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217; . . ."

PROBLEM 218

Illustrating Credits Against Net Income for Normal Tax—Taxable Interest on U. S. Obligations and War Finance Corporation Bonds

FACTS:

In Problem 72 there was illustrated the method of computing the amount of interest received on obligations of the United States and bonds of the War Finance Corporation required to be included in "Gross Income."

QUESTION:

How should this income be treated for normal tax purposes?

ANSWER:

The interest stated above should be added to the personal exemption and other credits allowed under section 216 (if any) and that total deducted from net income before computing the normal tax.

REFERENCE:

Sec. 216: "That for the purpose of the normal tax only there shall be allowed the following credits: . . .

(b) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 213; . . ."

CORPORATIONS:

A corporation subject to income tax is permitted to include as a credit against net income the amount received as interest on obligations of the United States and War Finance Corporation bonds which is required to be included in gross income.

REFERENCE:

Sec. 236: "That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits: . . . (a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 233; . . ."

PROBLEM 219

Illustrating the Adjustment of Credit Against Net Income for the Purpose of Computing Income Tax in Case a Domestic Corporation Files a Return for Less Than Twelve Months

FACTS:

The Pulchra Candy Company of New York, a domestic corporation, was organized July 1, 1922. Its net income for the six months ending December 31, 1922 (the close of its established fiscal year) was $11,000.

QUESTION:

What is the credit allowable against the corporation's net income in computing the income tax?

ANSWER:

The credit allowable is $\frac{6}{12}$ of the specific credit of $2,000, or $1,000. Art. 626, Reg. 62 provides that ". . . this prorated

credit shall be applied to the net income before such net income is placed on an annual basis." [See Sec. 226 (c) quoted under Problem 196.]

REFERENCE:

Sec. 236: "That for the purpose only of the tax imposed by section 230 [1] there shall be allowed the following credits: . . . (b) in the case of a domestic corporation the net income of which is $25,000 or less, a specific credit of $2,000; . . ."

Sec. 239 (b): "Returns made under this section shall be subject to the provisions of sections 226 and 228. When return is made under section 226 [2] the credit provided in subdivision (b) of section 236 shall be reduced to an amount which bears the same ratio to the full credit therein provided as the number of months in the period for which such return is made bears to twelve months."

PROBLEM 220

Illustrating Income Tax Credit in Case of Corporation Whose Income Subject to Normal Tax is Slightly More Than $25,000

FACTS:

The X Y Z Corporation has a net income in 1921, of $25,100. The corporation has no excess-profits tax.

PROBLEM:

Compute the income tax.

SOLUTION:

Income	$25,100		$25,100
10% of income	2,510	Exemption	2,000
			$23,100
Tax at 10%			2,310
Add: Excess of income over $25,000			100
Income tax			$ 2,410

[1] Sec. 230 imposes the income tax.

[2] Sec. 226 relates to returns for a period of less than twelve months.

REFERENCE:

Sec. 236 (b): "In the case of a domestic corporation the net income of which is $25,000 or less, a specific credit (shall be allowed) of $2,000; but if the net income is more than $25,000 the tax imposed by section 230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. . . ."

NOTE:

No benefit will arise from this limitation except in the case of a corporation the amount of whose income to which the 10% is to be applied is in excess of $25,000 but less than $25,200. In 1922 and succeeding years, when the income tax rate is 12½%, the amount would have to be in excess of $25,000 but less than $25,250 in order that the limitation referred to in Sec. 236 (b) shall apply.

PROBLEM 221

Illustrating Withholding of Taxes in the Case of Nonresident Foreign Corporations

FACTS:

The British-American Trading Company organized under the laws of the United Kingdom of Great Britain and Ireland maintains no office in the United States but keeps a substantial bank balance in a New York bank on which it draws for the payment of goods purchased in the United States. The company also has several bonds (none of which contain a tax free covenant clause) of American corporations in the custody of the New York bank which acts as its agent collecting the coupons as they mature, crediting the account of the company with the proceeds. Interest is credited by the bank on the current balances on deposit.

QUESTION:

Will any part of such income be withheld at the source, and if so, at what rates in 1921 and 1922?

ANSWER:

Since the foreign corporation does not have a place of business in the United States the interest it receives on its bank deposits is not taxable. In the case of the interest on the bonds of the American corporations, the payor companies are required to withhold 10% of the amount paid in 1921 and 12½% of the amount paid in 1922 when such coupons are collected by the the New York bank as agents for the British-American Trading Company.

REFERENCE:

Sec. 237: "That in the case of foreign corporations subject to taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same condition as provided in that section: Provided, That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum."

NOTE:

See Problem 175 for illustration of section 221.

PROBLEM 222

Illustrating Filing of Income-Tax Return by Personal Service Corporation

FACTS:

The Alexander Mechanical Engineering Society, according to the regulations laid down by the Bureau of Internal Revenue, is a personal service corporation.

QUESTION:

What is the procedure for this society to follow in respect to filing a return of net income for the calendar year 1921 (its accounting period)?

ANSWER:

The Revenue Act of 1921, Sec. 239 (a) states "That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed."

REFERENCE:

Art. 624; Regulations 62: "Every personal service corporation must make a return of income, regardless of the amount of its net income. It shall be made for the taxable year of the personal service corporation; that is, for its annual accounting period (fiscal year or calendar years, as the case may be), regardless of the taxable year of its stockholders. See sections 200, 212, and 218 of the statute, and articles 1523-1532, 25, 26 and 336-339. For the calendar year 1921 the return shall be made on Form 1065. If the personal service corporation makes any change in its accounting period, it shall render the return in accordance with the provisions of section 226 of the statute and article 431. The return of a personal service corporation covering any period beginning prior to January 1, 1922, should state specifically (a) the items of its gross income enumerated in section 213 of the statute; (b) the deductions enumerated in section 214 of the statute, other than the deduction provided in paragraph (11) of subdivision (a) of that section; (c) the amount specified in subdivisions (a) and (b) of section 216 of the statute received by the personal service corporation; (d) the amount of any income, war-profits, and excess-profits taxes of the personal service corporation paid during the taxable year to a foreign country or to any possession of the United States, and the amount of any such taxes accrued but not paid during the taxable year; (e) the amounts distributed by the corporation during its taxable year, with the dates of distribution and the names of the distributees; (f) the names and addresses of the stockholders of the corporation and their respective shares in such corporation at the close of its taxable year, and on December 31, 1921; (g) such facts as tend to show whether or not the corporation is a personal service corporation with reference to any period beginning prior to January 1, 1922; and (h) such other facts as are required by the form. . ."

PROBLEM 223

Illustrating Filing of Tax Return by Domestic Corporation Having No Net Income

FACTS:

The Harrison Leather Company of New York showed a loss

for the calendar year 1920, and so reported in a letter addressed to the Commissioner of Internal Revenue and signed by the cashier of the company.

QUESTION:

What would have been the proper proceeding?

ANSWER:

The corporation should have filed form 1120 with the collector, showing its gross income and the deductions and credits allowed.

REFERENCES:

Sec. 239 (a): "That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The return shall be sworn to by the president, vice-president, or other principal officer and by the treasurer or assistant treasurer."

Art. 621, Regulations 62: "Every corporation not expressly exempt from tax must make a return of income, regardless of the amount of its net income. In the case of ordinary corporations the return shall be on form 1120. . . ."

PROBLEM 224

Illustrating Filing of Income Tax Returns by Receivers of Domestic Corporation

FACTS:

The Glen Cove Railroad Company, organized under the laws of the State of New York, being unable to meet its obligations, has been placed in the hands of a receiver appointed by the court. The receiver continues to operate the railroad.

QUESTION:

Is it necessary to file a return for that company? If so, by whom must the return be filed?

ANSWER:

It is necessary to file a return on form 1120, which should

be made up by the receiver. The receiver must continue to file returns of income for each year or part of year in which he is acting in the capacity of receiver.

REFERENCES:

Sec. 239 (a): "In cases where receivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control."

Art. 622, Regulations 62: "Receivers, trustees in dissolution, trustees in bankruptcy, and assignees, operating the property or business of corporations, must make returns of income for such corporations on Form 1120, covering each year or part of a year during which they are in control. Notwithstanding that the powers and functions of a corporation are suspended and that the property and business are for the time being in the custody of the receiver, trustee, or assignee, subject to the order of the court, such receiver, trustee or assignee, stands in the place of the corporate officers and is required to perform all the duties and assume all the liabilities which would devolve upon the officers of the corporation were they in control. A receiver in charge of only part of the property of a corporation, however, as a receiver in mortgage foreclosure proceedings involving merely a small portion of its property, need not make a return of income."

Art. 424, Reg. 62: "A receiver who stands in the stead of an individual or corporation must render a return of income and pay the tax for his trust, but a receiver of only part of the property of an individual or corporation need not. If the receiver acts for an individual the return shall be on form 1040 or 1040 A. When acting for a corporation a receiver is not treated as a fiduciary, and in such a case the return shall be made as if by the corporation itself. . . ."

PROBLEM 225

Illustrating Filing of Income Tax Return by Foreign Corporations Having no Place of Business in the United States

FACTS:

The Dominion Corporation, Ltd., has considerable business in the United States, but maintains no office, transacting its business through an agent.

QUESTION:

How should the corporation report its income from sources within the United States?

ANSWER:

Every foreign corporation having income from sources within the United States must make a return of income. If such a corporation has no place of business here, but has an authorized agent in the United States, the agent shall file the return.

REFERENCES:

Sec. 239 (a): " . . . If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. . . ."

Art. 625, Regulations 62: "Every foreign corporation and corporation satisfying the conditions set forth under section 262, having income from sources within the United States, must make a return of income. . . . If such a corporation has no office or place of business here, but has a resident agent, he shall make the return. It is not necessary, however, for it to be required to make a return that the foreign corporation shall be engaged in business in this country or that it have any office, branch, or agency in the United States. . . ."

PROBLEM 226

Illustrating What Information With Respect to Dividend Payments is Required to be Included in a Corporation Return

FACTS:

The National Metal Company is a domestic corporation and has over 200 stockholders. Its taxable year ends September 30. It was about to file its income and profits-tax return for the taxable year ended September 30, 1921, when the Revenue Act of 1921 was enacted. In order to study the requirements of the new act it secured an extension of time until January 15, 1922, to file said return. The treasurer of the company was charged with the duty of the preparation of said return. In studying the Revenue Act of 1921, he observed the provision of paragraph (c) of Section 239 to the effect that there is required

to be included in the return a statement of such facts as will enable the Commissioner to determine the portion of the taxable year's profits which have been distributed or ordered to be distributed, during the taxable year. He is puzzled as to just what information he should furnish to meet requirements.

QUESTION:

What is the purpose of the requirements set forth in paragraph (c) of section 239 above mentioned, and how may such requirements be met in this case?

ANSWER:

The information required under paragraph (c) of section 239 on the return as to dividends paid and declared during the year is probably to enable the Commissioner to determine whether the corporation is being availed of to prevent the imposition of the surtax upon its stockholders through the medium of permitting its profits to accumulate beyond the reasonable needs of the business, and differs from the return that *may* be required by the Commissioner to enable him to verify the fact that the dividends paid have been included on the personal return of each stockholder. (See Problem 269 for illustration of the latter requirement.) The corporation return form in use during 1920 outlined a schedule to be followed in reconciling taxable net income with book income and surplus at the beginning and end of the taxable year. If the corporation will render its return on the old form and furnish the information on the schedule just referred to, together with a statement of the dividends declared, it is believed the corporation will meet the requirements of the statute, in the connection referred to in this problem. It is possible, however, that the Bureau may later require the filing of an amended return on any new forms which it may issue.

REFERENCE:

Sec. 239 (c): "There shall be included in the return or appended thereto a statement of such facts as will enable the Commissioner to determine the portion of the earnings or profits of the corporation (including gains, profits and income not taxed) accumulated

during the taxable year for which the return is made, which have been distributed or ordered to be distributed, respectively, to its stockholders or members during such year."

PROBLEM 227

Illustrating Consolidated Returns—Class A, or Parent-and-Child, Relationship

FACTS:

M. Company, a domestic corporation, owns all the outstanding capital stock of domestic corporation X. The latter corporation in turn owns all the outstanding capital stock of domestic corporation Y. These conditions prevailed during the entire taxable year ended in 1921.

QUESTION:

Are the returns of the three corporations to be consolidated in 1921?

ANSWER:

Yes; this is a so-called Class A, or parent-and-child, consolidation, one corporation owning the entire outstanding capital stock of another. It will be noted that the ownership of "substantially all the stock" is referred to in the Revenue Act of 1921. Under previous acts the ownership or control of not less than 95 per cent of such outstanding voting capital stock has been accepted as satisfying the requirement that substantially all of the stock be owned or controlled. Under Article 633 of Regulations 62, however, it is made clear that a lower percentage of ownership or control when considered in conjunction with other existing factors influencing invested capital or income or both may warrant consolidating the returns of the corporations concerned.

REFERENCE:

Sec. 240 (c): ". . . Two or more domestic corporations shall be deemed to be affiliated (1) if one corporation owns directly or controls through closely affiliated interests or by a nominee or nominees substantially all the stock of the other or others."

PROBLEM 228

Illustrating the Requirement to File Consolidated Returns—Class B, or Brother-brother, Relationship

FACTS:

The outstanding voting capital stock of domestic corporations X and Y was owned during the calendar year 1921, as follows:

Stockholder	Company	Portion of total stock of company held by each
P. S. Speer	X	60%
	Y	60%
W. T. Gray	X	40%
	Y	40%

Both the above corporations keep their books on the calendar-year basis.

QUESTION:

Are Companies X and Y required to file consolidated returns for the taxable year 1921?

ANSWER:

Yes.

REFERENCES:

Sec. 240 (c): "For the purpose of this section two or more domestic corporations shall be deemed to be affiliated . . . (2) if substantially all the stock of two or more corporations is owned or controlled by the same interests."

Sec. 240 (e): "Corporations which are affiliated within the meaning of this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918."

PROBLEM 229

Illustrating Option of Filing Consolidated Returns or Separate Returns for Taxable Years Beginning on or after January 1, 1922

FACTS:

The outstanding voting capital stock of domestic corporations X and Y is owned by the same stockholders in the same proportions, rendering these corporations affiliated under the law. The accounting periods of the two corporations end December 31.

QUESTION:

Are corporations X and Y required to file consolidated returns for the taxable year 1922 and subsequent years?

ANSWER:

The companies have the option of filing consolidated returns for 1922 or separate returns. The basis which is adopted for the year 1922 cannot be subsequently changed, however, unless permission to do so is granted by the Commissioner.

REFERENCE:

Sec. 240 (a): "That corporations which are affiliated within the meaning of this section may, for any taxable year beginning on or after January 1, 1922, make separate returns or, under regulations prescribed by the Commissioner with the approval of the Secretary, make a consolidated return of net income for the purpose of this title, in which case the taxes thereunder shall be computed and determined upon the basis of such return. If return is made on either of such bases, all returns thereafter made shall be upon the same basis unless permission to change the basis is granted by the Commissioner."

PROBLEM 230

Illustrating Consolidated Returns—Fiscal Years Ending in 1922

FACTS:

Domestic corporation A owns all the capital stock of domestic

corporation B. Both companies close their fiscal year November 30th.

QUESTION:

Are they required to file a consolidated return for the fiscal year ended November 30, 1922?

ANSWER:

Yes; the option given in section 240 (a) permitting corporations which are affiliated within the meaning of that section to file consolidated or separate returns applies only to corporations reporting for a taxable year beginning on or after January 1, 1922.

REFERENCE:

Sec. 240 (e): (Quoted under Problem 228.)

PROBLEM 231

Illustrating Consolidated Returns—Allocation of Taxes

FACTS:

Domestic Corporations A, B and C file a consolidated return for their taxable year ending December 31, 1921. The consolidated net income is $100,000, of which Corporation A's portion is $50,000, Corporation B's $30,000, and Corporation C's $20,000. The total tax payable is $20,000. The consolidated return contains no direction as to the allocation of the tax against the several corporations.

QUESTION:

What amount of tax will be assessed against the respective corporations?

ANSWER:

The total tax will be allocated to the several corporations on the basis of the proportion of net income of each corporation to the consolidated net income, as follows:

A	Corporation	50%	$10,000
B	"	30%	6,000
C	"	20%	4,000
			$20,000

The tax may be allocated to the several corporations in any proportion that may be agreed upon among them, but in the absence of such agreement the allocation will be made as above outlined.

REFERENCE:

Sec. 240 (b): "In any case in which a tax is assessed upon the basis of a consolidated return, the total tax shall be computed in the first instance as a unit and shall then be assessed upon the respective affiliated corporations in such proportions as may be agreed upon among them, or, in the absence of any such agreement, then on the basis of the net income properly assignable to each."

PROBLEM 232

Illustrating Case in Which the Commissioner of Internal Revenue May Request a Consolidation of the Account of a Foreign Corporation with that of a Domestic Corporation for the Purpose of Properly Apportioning Gains or Losses, Deductions and Capital

FACTS:

The Irish Linen Company, a foreign corporation manufacturing linens in Ireland, sells them to the Irish Linen Corporation of New York, a domestic corporation 100% owned by the foreign corporation. The selling price of the linens to the American corporation is considerably above the market price in Ireland, with the result that the American corporation shows no income while the foreign corporation shows a large income. This situation prevailed during 1921.

QUESTION:

Is the American corporation subject to tax, and if so, how?

ANSWER:

The Commissioner of Internal Revenue would probably request a full disclosure of the relationship between the two corporations, and he would no doubt direct that the accounts of the foreign and domestic companies be consolidated to the end that the income and capital be equitably distributed as between the foreign corporation and the domestic corporation for the purpose of assessing against the latter its proper income and excess-profits tax.

REFERENCE:

Sec. 240 (d): "For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: Provided, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned or controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades and businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."

PROBLEM 233

Illustrating Rates of Tax on Domestic Life Insurance Companies

FACTS:

The New York American Life Insurance Company, organized under the laws of the State of New York, in making up its income-tax return for the calendar year 1921 is in doubt as to what Federal taxes it is subject to.

QUESTION:

Are life insurance companies subject to (1) income tax, (2) war-profits and excess-profits tax and (3) capital-stock tax?

ANSWER:

In the calendar year 1921 and all subsequent taxable years, the only Federal tax imposed on life insurance companies is the income tax at the same rate as applies to other corporations

subject to that tax. In accordance with section 230 the rate for 1921 is 10%; for 1922 and each subsequent year the rate is 12½%. Life insurance companies are exempt from the capital-stock tax and the war-profits and excess-profits taxes.

REFERENCE:

Sec. 243: "That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows: (1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230; . . ."

See note under Problem 234.

PROBLEM 234

Illustrating Rates of Taxes on Foreign Life Insurance Companies

FACTS:

The Dublin Life Insurance Company, incorporated under the laws of Great Britain and Ireland, requests its general agent in New York to report as soon as possible what United States taxes it is subject to for the calendar year 1921. The reserve funds of the company, held for the fulfillment of its life insurance and annuity contracts, comprise more than 50% of its total reserve funds.

QUESTION:

What should the agent report to the company?

ANSWER:

For the calendar year 1921 the company is subject to an income tax of 10% on its net income from sources within the United States. For the calendar year 1922, and all subsequent years, the rate is 12½%. It is not subject to the capital-stock tax nor excess-profits or war-profits taxes.

REFERENCES:

Sec. 242. That when used in this title the term "life insurance

company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insurance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds.

Sec. 243. "That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows: . . . (2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230."

NOTE:

Sec. 1000 relates to the Capital-Stock Tax.

Title III imposes the war-profits and excess-profits taxes. This title is in effect only for the calendar year 1921.

Sec. 230 imposes a rate of tax of 10% for the calendar year 1921 and 12½% for all subsequent years.

PROBLEM 235

Illustrating Deductions Allowed Life Insurance Companies—Interest From Municipal Bonds

FACTS:

The Jamaica Life Insurance Company of New York in preparing its income tax return for the calendar year 1921 finds that it has among its assets quite a number of municipal bonds.

QUESTION:

Is the interest on these bonds taxable?

ANSWER:

No. The interest received on these bonds must be included in the gross income of life insurance companies, differing in this respect from corporations subject to the tax imposed by section 230, but such interest is deductible in computing net income.

REFERENCES:

Sec. 244 (a): "That in the case of a life insurance company, the term 'gross income' means the gross amount of income received during the taxable year from interest, dividends, and rent."

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less—(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title; . . ."

Sec. 213 (b) (4) (c): (Quoted under Problem 72.)

PROBLEM 236

Illustrating Deductions Allowed Life Insurance Companies —Deduction on Account of Reserves

FACTS:

The Ideal Insurance Company of Hartford, Conn., issuing policies covering life, health and accident insurance combined in the one policy issued for life on the weekly payment plan not subject to cancellation, has drawn up a trial balance as of December 31, 1921, for the purpose of preparing its income-tax return and the question of the deductions allowable on account of the Reserves has come up. The following items appear on the trial balance as of December 31, 1921:

Interest from New York State Bonds	$ 8,000
Reserve funds required by law	170,000
Reserve funds not required by law on the combined policies as above	125,000
Its balance sheet as of December 31, 1920 shows:	
Reserve funds required by law	$ 150,000
Reserve funds not required by law (as above)	100,000

The company has stated the facts to the Commissioner with respect to the reserve fund not required by law, and he has notified them that he is satisfied such reserve is necessary for the protection of the holders of the combined policy described above.

QUESTION:

What deduction, if any, is allowable on account of the reserves above mentioned?

ANSWER:

In the case of life insurance companies issuing the combined

policy referred to in "Facts" above, only such part of the reserve funds not required by law, as the Commissioner finds to be necessary for the protection of such policy-holders forms the basis for the deduction, in addition to the reserve required by law, which is the only basis for the deduction in the case of life insurance companies not issuing such policy. The excess, if any, of 4% of the mean of the reserves at the beginning and end of the year over the amount of tax free interest received is the deduction allowed on account of such reserves. In this case, the allowable deduction is computed as follows:

4% of \$160,000, which is the mean of the reserve account required by law $\left(\frac{\$150,000+\$170,000}{2}\right)$	\$6,400
4% of \$112,500, which is the mean of the reserve not required by law $\left(\frac{\$100,000+\$125,000}{2}\right)$	4,500
	\$10,900
Amount of income received from nontaxable securities.	8,000
Amount allowed as a deduction from gross income....	\$ 2,900

REFERENCES:

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less. . . . (2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;"

See Problem 235 for quotation paragraph 1 of subdivision (a) of section 245.

Sec. 244 (b): "The term 'reserve funds required by law' includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds main-

tained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use."

PROBLEM 237

Illustrating Deductions Allowed Life Insurance Companies—Dividends Received

FACTS:

The Star Life Insurance Company of Newark, New Jersey, holds in its investment account:

200 Shares of the Porto Rico Sugar Company.

100 Shares of the British American Trading Company of London, England.

Neither of these companies has ever derived any income from sources within the United States. During its taxable year 1921, the insurance company received dividends on the stock held in both companies.

QUESTION:

Are the dividends above mentioned a proper deduction from gross income?

ANSWER:

No, for they are received from foreign corporations which have derived no income from sources within the United States.

REFERENCE:

Sec. 245 (a): "That in the case of a life insurance company, the term 'net income' means the gross income less. . . . (3) The amount received as dividends (a) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (b) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;"

PROBLEM 238

Illustrating Deductions Allowed Life Insurance Companies —Reserve for Dividends

FACTS:

The All American Life Insurance Company of Brooklyn, N. Y. up to the year 1906 issued life insurance policies the dividends upon which were deferred for from 5 to 20 years. After 1906, no other policies of this nature were written by the company. On Dec. 31, 1921, the close of its taxable year, there was carried on its books a ''Reserve for Dividend Payments'' in the amount of $105,000 of which $25,000 was payable during the calendar year 1922.

QUESTION:

May any part of this reserve be deducted from the company's gross income?

ANSWER:

Yes, 2% of the reserve after deducting the payments due for the following year; i. e., 2% of, ($105,000—$25,000), or $1,600 is deductible from gross income.

REFERENCE:

Sec. 245 (a): "That in the case of a life insurance company, the term 'net income' means the gross income less. . . . (4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;"

PROBLEM 239

Illustrating Deductions Allowed Life Insurance Companies —Investment Expenses

FACTS:

The Hartford Life Insurance Company of Connecticut main-

tains an office in Kansas City, Missouri, for the express purpose of investing part of its funds in loans on farms located in the surrounding country. The expenses of this office for the taxable year 1921, including rent, salaries, legal fees, etc., were $25,000. A similar office is maintained in New York City for investment in bonds, etc., in charge of a vice president of the company. The expenses of this office for salaries, rent, brokers' commissions, etc., were $37,000. Balance sheets of the company as at the beginning and end of the year 1921, showed book values of its invested assets of $4,700,000 and $5,200,000 respectively.

QUESTION:

What part, if any, of the expense of maintaining these offices is deductible?

ANSWER:

Such investment expenses are deductible but to an amount not in excess of ¼ of 1% of the average at the beginning and end of the taxable year of the invested assets of the company. In this case the allowable deduction is computed as follows:

Book value of invested assets at beginning of year ...	$4,700,000
Book value of invested assets at end of year	5,200,000
Total	$9,900,000
Mean	4,950,000

¼ of 1% of average=$12,375=allowable deduction.

REFERENCE:

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less . . . (5) Investment expenses paid during the taxable year: Provided, That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;"

PROBLEM 240

Illustrating Deductions Allowed Life Insurance Companies—Taxes

FACTS:

During the year 1920, the Puritan Life Insurance Company of Rhode Island had to take over several parcels of real estate on account of bad loans. During 1921 it paid city and county taxes on this real estate amounting to $1,200. No part of these taxes was for local benefits and no part of the real estate was occupied by the company.

QUESTION:

Are these taxes allowable deductions?

ANSWER:

Yes, as they were for taxes not assessed against local benefits and the real estate on account of which the taxes were paid was not occupied in whole or in part by the company.

REFERENCE:

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less . . . (6) taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes;"

See Problem 242 for illustration of limitation of deduction for taxes paid on real estate owned and occupied in whole or in part by the company.

PROBLEM 241

Illustrating Deductions Allowed Life Insurance Companies —Depreciation, Specific Exemption

FACTS:

The Royal Life Insurance Company of Delaware, Maryland, in preparing its Federal income tax return for the calendar year 1921, requested information as to whether life insurance companies were to treat the following deductions the same as domestic corporations subject to tax:

(1) Depreciation.

(2) Specific exemption allowed.

QUESTION:

Are depreciation, and the specific exemption of $2,000 for domestic corporations having a net income of less than $25,000 to be treated in a different manner by life insurance companies than by corporations subject to the tax imposed by section 230?

ANSWER:

The method of computing depreciation is the same, except that on real estate owned by a life insurance company that is occupied in whole or in part by such company, no deduction for depreciation of such property is allowed unless the rental value of the space so occupied is included in gross income. (See Problem 242 for illustration of such inclusion). In the case of life insurance companies having a net income of less than $25,000, the specific exemption of $2,000 is to be taken as a deduction from gross income, instead of a credit against net income subject to the income tax.

REFERENCE:

Sec. 245 (a): "That in the case of a life insurance company the term 'net income' means the gross income less. . . . (7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March

1, 1913; . . . (9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. . . . (b) No deduction shall be made under[1] paragraphs (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied."

PROBLEM 242

Illustrating Deductions Allowed Life Insurance Companies —Taxes and Depreciation on Property Owned and Occupied in Part

FACTS:

The Fidelity Life Insurance Company of Newark, N. J. purchased an eight-story office building in December, 1914, for $2,000,000; the company located its main offices in this building. During the calendar year 1921 the company occupied only three floors and rented the remaining five floors of the building at an annual rental of $120,000. In 1921 the taxes on this building were $20,000, and operating expenses were $75,000. The building was estimated to have a life of fifty years from date of purchase; accordingly depreciation at the rate of 2% per annum on cost was written off each year on account of this building. No improvements have been made since that date.

QUESTION:

Is the company allowed a deduction from its gross income for such taxes and for depreciation on the building?

[1] Paragraphs 6 and 7 refer to the deduction of taxes and depreciation.

ANSWER:

The company is allowed a deduction from gross income on account of the taxes paid and on account of the depreciation of the building only if there is included in gross income the rental value of the space so occupied, which rental values, however, shall not be less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses) at the rate of 4% per annum of the book value at the end of the taxable year in question.

On the basis of the rents received from the five floors not occupied by the company, the rental value of the three floors occupied by the company amounts to $72,000. However, this value is less than the minimum rental value prescribed by the statute. The following shows the computation of this minimum rental value.

Cost of building	$2,000,000
Depreciation (7 years at $40,000 per year)	280,000
Book value of building, December 31, 1921	$1,720,000
4% of $1,720,000 book value of real estate December 31, 1921	$ 68,800
Operating expenses	75,000
Taxes	20,000
Depreciation in 1921	40,000
Gross rental value entire space	$203,800
Rents received	120,000
Minimum rental value of space occupied by the company	$ 83,800

REFERENCE:

Sec. 245 (b): (Quoted under Problem 242.)

PROBLEM 243

Illustrating Taxable Net Income of Foreign Life Insurance Companies

FACTS:

At the request of its general agent in New York, the London and Globe Life Insurance Company, Ltd., of London, England, has forwarded the following information to him for the United States income tax purposes:

Total net income for the calendar year 1921 from all sources	$ 840,000
Total reserve funds as at December 31, 1921	3,500,000
Reserve funds at December 31, 1921 required by law upon business transacted within the United States.	1,000,000

PROBLEM:

Compute its taxable net income.

SOLUTION:

$\$840,000 \times \frac{1,000,000}{3,500,000} = \$240,000 =$ the taxable net income from sources within the United States.

REFERENCE:

Sec. 245 (c): "In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted."

PROBLEM 244

Illustrating Rate of Tax on Foreign Insurance Companies Other Than Life or Mutual Insurance Companies, for the Taxable Year 1922

FACTS:

The Scotland Fire Insurance Co., Ltd., of London, England,

writes policies of fire insurance in the United States. It has inquired of its agent in the United States what tax it is subject to for the year 1922.

QUESTION:

How should this question be answered by the agent?

ANSWER:

The corporation is subject to the income tax of 12½% on its net income from sources within the United States, but is exempt from the capital-stock tax.

REFERENCE:

Sec. 246 (a): "That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows: . . . (2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230."

NOTE:

Sec. 230 provides a tax of 12½% for the calendar year 1922, and thereafter. Section 1000 imposes the capital stock tax.

PROBLEM 245

Illustrating Manner of Paying Tax in Case an Extension of Time for Filing a Return is Granted a Taxpayer

FACTS:

Arthur C. Sylvester, a traveling salesman, always filed his tax return on a calendar year basis. He was granted an extension of 60 days for filing his income tax return for the calendar year 1921, by the Commissioner of Internal Revenue due to the fact that he was on a business trip to the Pacific Coast and his records were in New York thus making it impossible for him to prepare his return on time.

QUESTION:

When will Mr. Sylvester be required to pay his Federal income tax? In the case of deferred payments, must interest also be paid?

ANSWER:

Mr. Sylvester has the option of (a) paying the entire tax due on or before May 24, 1922, (the date the sixty-day extension expires) plus interest on ¼ of the total tax due (the first installment, the payment of which was extended with the extension of date for filing return) at the rate of ½ per centum per month from March 15 to the date of filing the return, or (b) paying the tax due in four equal installments payable one fourth on or before May 24, 1922, plus interest on such installment at the rate of ½ per centum per month from March 15, 1922, to May 24, 1922, one fourth on the fifteenth day of June, one fourth on the fifteenth day of September and one fourth on the fifteenth day of December, 1922.

REFERENCE:

Sec. 250 (a): "That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four installments, each consisting of one fourth of the total amount of the tax. The first installment shall be paid at the time fixed by law for filing the return, and the second installment shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as part of such installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension had been granted, until paid. If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a single payment instead of in installments, in which case the total amount

shall be paid on or before the time fixed by law for filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension."

PROBLEM 246

Illustrating Effect Upon Subsequent Installments in Case of Non-Payment of Installment of Tax When Due

FACTS:

The Monroe Biscuit Company filed their tax return for the fiscal year ending August 31, 1921 on November 14, 1921, and paid the first installment of the tax at the same time the return was filed. The second installment of the tax became due February 15, 1922 but the company was unable to meet the payment as its liquid capital was exhausted and it failed to obtain further credit from its bankers. The company was solvent but was unable to make collections rapidly enough to meet its current obligations.

QUESTION:

What effect, if any, will the fact, that the second installment is not paid when due, have upon the third and fourth installments which are payable May 15 and August 15, 1922, respectively?

ANSWER:

The whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector as soon as any installment is not paid when due.

REFERENCE:

Sec. 250 (a): ". . . If any installment is not paid when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector. . . ."

PROBLEM 247

Illustrating Case in Which Taxpayer Finds That Excessive Amount of Tax Has Been Reported, and Method of Adjusting Error

FACTS:

The Cardigan Lumber Company filed an income and profits-tax return February 15, 1922 for the fiscal year ending November 30, 1921. The return showed a total tax due of $25,980, and the company paid the first installment thereof, $6,495, on the date the return was filed. During the month of April a firm of certified public accountants audited the books and tax return of the company and found that the income and excess-profits tax for the fiscal year 1921 had been erroneously computed, and that the correct amount of the total was $16,256.

QUESTION:

How may the company adjust the error?

ANSWER:

The company should file a claim for abatement of the excessive amount reported on the return, or $9,724. The installments should be recomputed and $2,431, representing the excessive amount paid on the first installment, should be applied against the payment of the second installment of the tax due May 15, 1922, leaving a balance of $1,633 to be paid on this installment. The corrected amounts of the third and fourth installments, due August 15 and November 15, 1922, respectively, will be $4,064 each.

REFERENCES:

Art. 1061 (a), Regulations 62: *"Refund, credit, and abatement adjustments.*—Reduction of internal revenue assessments and adjustments of overpayments of revenues will be accomplished in one of three ways:

"(a) On the basis of an application submitted by a taxpayer on Form 843, together with appropriate supporting evidence to be filed in the office of the collector of internal revenue of the district in which the tax is assessed. . . ."

Sec. 250 (b): "As soon as practicable after the return is filed

the Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as computed, the excess so paid shall be credited against the subsequent installments; . . ."

Sec. 3220 of the Revised Statutes: "The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

PROBLEM 248

Illustrating Case in Which, Due to an Error in Judgment on the Part of the Taxpayer, the Amount of Tax Paid is Less Than That Which Should Have Been Paid

FACTS:

The Speedking Automobile Company operated about fifty taxicabs in the city of New York. In preparing its income and excess-profits tax return for the taxable year 1921 it claimed as a deduction from gross income, depreciation at the rate of fifty per centum per annum upon all its cars, which depreciation the auditor of the company had written off as a matter of conservative accounting. Representatives of the Bureau of Internal Revenue found upon investigation that some of the cars were discarded in two years but the average life of all the cars was four years. They, therefore, reduced the depreciation allowable as a deduction from the taxable income of the company to 25 per centum per annum on all cars. The officials of the Bureau of Internal Revenue are convinced that the depreciation adjustment of the company was not due to negligence or intentional

disregard of authorized rules and regulations with knowledge thereof.

QUESTION:

Will the company be required to pay more than the additional tax due as a result of the depreciation adjustment?

ANSWER:

Yes, the company will be required to pay interest at the rate of one-half of one per centum per month on the deficiency in the tax from the time the tax was due.

REFERENCE:

Sec. 250 (b): ". . . If the amount already paid is less than that which should have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (hereinafter called deficiency), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector."

PROBLEM 249

Illustrating Case in Which, Through Negligence, Less Tax Is Reported Than the Amount Actually Due

FACTS:

The Oriental Silk Company, a corporation organized under the laws of the State of New York, imports raw silk from China and Japan and sells it to manufacturers of silk thread. In preparing its income and excess-profits tax return for the taxable year 1921, the treasurer took as a deduction from income the income and excess-profits tax paid by the company in 1921 for the taxable year 1920.

QUESTION:

May the above company be subject to a penalty for reporting less taxable income than it should have reported?

ANSWER:

Yes, the Bureau has regarded the taking of income and excess-

profits taxes as a deduction from gross income as due to negligence or intentional disregard of authorized regulations with knowledge thereof, and the company may therefore be required to pay a penalty of 5% of the total amount of the deficiency in the tax reported, together with interest at the rate of one per centum per month on the amount of such deficiency in the tax from the time it was due. This penalty may be compromised.

REFERENCE:

Sec. 250 (b): ". . . If the amount already paid is less than that which should have been paid, . . . (and) if any part of the deficiency is due to negligence or intentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector."

PROBLEM 250

Illustrating Liability in Case of Fraudulent Return

FACTS:

Mr. William A. Bragg, a real estate dealer, purchased a tract of land in 1917, known as Pinehurst Park, for $10,000. On August 16, 1921, he sold the above land for $20,000 to a British subject who was not required to file an income tax return in the United States. In preparing his income tax return for the taxable year, 1921, Mr. Bragg failed to report the profit on the above sale. Later he boasted of the fact to two salesmen who were in his employ, stating to them that he had "put one over" on the government and had succeeded in avoiding the payment of a tax on $10,000 profit derived from the sale of Pinehurst Park. In the latter part of March, 1922, Mr. Bragg had a quarrel with the above salesmen and discharged them. They immediately reported to the Commissioner of Internal Revenue at Washington,

D. C., the fact that Mr. Bragg had filed an incorrect return for the taxable year 1921, with the fraudulent intent of evading tax. An examination followed and fraudulent intent was proven.

QUESTION:

What payment will Mr. Bragg be required to make to the Bureau of Internal Revenue? Are there any penalties which may be imposed upon him?

ANSWER:

Mr. Bragg will be required to pay the deficiency in tax plus an additional tax equal to 50 per centum of the total amount of the deficiency in the tax. He is regarded as guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution.

REFERENCES:

Sec. 250 (b): ". . . If any part of the deficiency is due to fraud with intent to evade tax, then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent return, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector."

Sec. 1302 (b): "Any person who willfully refuses to pay, collect, or truly account for and pay over any such tax, make such returns or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the cost of prosecution."

PROBLEM 251

Illustrating Authority of Internal Revenue Bureau in Case Taxpayer Fails to File Return Required

FACTS:

The Weldon Clothing Company, a New Jersey corporation,

operated a retail clothing store in the city of Newark, N. J. It deliberately destroyed all of its accounting records for the calendar year 1921, and did not file an income and excess-profits tax return for this period as required. The Collector of Internal Revenue in due course instituted an examination of the matter as a result of which the bookkeeper testified that net earnings of approximately $80,000 were derived from the sales of the company during the calendar year 1921.

QUESTION:

What action is the Commissioner of Internal Revenue authorized to take with respect to the return of the company?

ANSWER:

The Commissioner is authorized to prepare a return for the company, and is required to assess the tax shown thereon, together with an amount equal to 25 per centum of the tax. The amount thus assessed is payable upon notice and demand by the collector.

REFERENCES:

Sec. 250 (c): "If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determined to be due under such return shall be paid upon notice and demand by the collector."

Sec. 3176, of Revised Statutes, as amended: "If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes.

"If the failure to file a return or list is due to sickness or absence, the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are

so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

PROBLEM 252

Illustrating Case in Which Additional Tax Cannot be Assessed by the Commissioner of Internal Revenue Without Permission of Taxpayer

FACTS:

The Mount Vernon Pipe Company, a corporation organized under the laws of the State of New York in December, 1908, had filed returns of income for each calendar year from 1909 to 1921, inclusive. In April, 1922, the returns of the above company (for the entire period from 1909 to 1921), were examined by an internal revenue agent. As a result of the examination the revenue agent recommended the assessment of additional taxes for the years 1909, 1913, 1916, 1917, 1918, 1920 and 1921. There was no fraudulent intent on the part of the company to evade taxes. The additional taxes as computed by the agent were the result of a somewhat different interpretation of various provisions of the Revenue Acts covering the years under review than the interpretation placed thereon by the taxpayer.

QUESTIONS:

Is the Internal Revenue Bureau authorized to assess additional tax for each of the above years? If not, what procedure is

necessary in order to carry out the recommendations of the revenue agent?

ANSWER:

Provided the findings of the revenue agent are found to be correct and in accordance with the rulings of the Internal Revenue Bureau, the additional tax for the taxable year 1921 may be assessed by the Commissioner within four years after the return was filed. The additional tax for all prior years, according to the provisions of the Revenue Act of 1922, is required to be determined and assessed within five years after the respective returns were filed; therefore, the additional tax recommended by the agent for the taxable years 1909, 1913, and 1916, cannot be assessed, as the five-year limitation has expired, unless both the Commissioner and the taxpayer consent in writing to the assessment and collection of the tax; and no suit or proceeding for the collection of the above taxes can be begun after the expiration of five years after the date when each return was filed. The additional tax recommended by the agent for the taxable years 1917, 1918, and 1920, may be assessed by the Commissioner (at the time of his findings in say September, 1922), as the returns covering the above taxable years were filed less than five years prior to September, 1922.

REFERENCE:

Sec. 250 (d): "The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years, shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled 'An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes,' approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act, or under prior income, excess-profits, or war-profits tax Acts, or of any

taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this Act."

PROBLEM 253

Illustrating Case in Which Commissioner is Required to Determine Tax Due for Estate of Decedent Within One Year from Date of Written Request by Executor of Estate

FACTS:

Mr. Isaac Pulaski who had a controlling interest in several silk mills and was a resident of East Orange, New Jersey, died August 31, 1921. The executor of his estate filed an income tax return on September 15, 1921, including therein the income received by the decedent from January 1, 1921 to the day of his death. On October 15, 1921 the executor wrote a letter to the Commissioner requesting an examination of the return of the decedent as soon as possible in order that all taxes due by the estate might be definitely determined and the estate closed.

QUESTION:

How long a period of time will the Commisioner be allowed for the determination and assessment of the tax due from the estate of Mr. Pulaski?

ANSWER:

According to the provisions of the Revenue Act of 1921, the Commissioner is allowed one year from the date of the written request made by the executor.

REFERENCE:

Sec. 250 (d): ". . . Provided, That in the case of income received during the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent. . . ."

PROBLEM 254

Illustrating Case in Which the Five-Year Limitation for the Assessment of Taxes Due, or for Proceeding for the Collection of Such Taxes by Suit, Does Not Apply —Fraudulent Return and Failure to File Required Return

FACTS:

The Melrose Textile Company, a corporation organized under the laws of Delaware in 1910, had its main office in Chicago, Ill. Internal Revenue agents investigated the records of this company in April, 1921, for the entire period from 1909 to 1920, inclusive, and found that no returns had been filed by the company for the taxable years 1910 and 1911, although profits of $6,000 and $10,000, respectively, were made during these years. For the taxable years 1915 and 1916 the president of the company furnished the agents with a set of books which reflected net income in agreement with the amounts reported on the return for those years. A few days later the revenue agents came across a ledger which reflected net income for 1915, amounting to $35,000 in excess of the amount reported by the company. Upon taking the matter up with the bookkeeper the latter stated that the ledger found by the agents reflected the true net income of the company for 1915, and that he (the bookkeeper) knew nothing whatsoever about the books which the president of the company had given the agents. Upon further investigation it was proved conclusively that a fraudulent return had been filed by the company for the taxable year 1915.

QUESTION:

In view of the fact that over five years have elapsed since the date the 1910 and 1911 returns should have been filed and that five years have elapsed since the fraudulent return for the taxable year 1915 was filed, will it be possible for the Bureau of Internal Revenue to collect the unpaid tax due for the above taxable years?

ANSWER:

Yes, the Bureau has the power to assess and collect or bring suit for the collection of such tax at any time after it becomes due.

REFERENCE:

Sec. (250 (d): ". . . Provided further, That in the case of a false or fraudulent return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes due. . . ."

PROBLEM 255

Illustrating Case in Which Five-Year Limitation For Assessment of Additional Tax Under Revenue Act of 1918 Does Not Apply—Deductions Tentatively Allowed

FACTS:

The Caltex Oil Company, an oil producer, filed its income and profits tax return for the calendar year 1917 on May 15, 1918, having obtained from the Commissioner an extension of time in which to file said return. This return showed a net income of $1,350,922.91, with a total income and profits-tax liability of $391,872.65. The depletion which the company claimed as a deduction from gross income on this return amounted to $987,674.32 and was based upon cost, March 1, 1913 value, and discovery value, as the case might be. Field examiners of the Bureau of Internal Revenue made an investigation of this return during 1921 as a result of which they recommended certain changes in invested capital and also recommended that the allowable depletion deduction be limited to $500,000.00. Upon consideration of these recommendations by the officials of the Bureau of Internal Revenue in Washington and after several conferences with the representatives of the Caltex Oil Company, the Commissioner determined the correct invested capital. The net income was also adjusted, $750,000 being tentatively allowed as a deduction on accounts of depletion.

The understanding which the Commissioner reached with the company's representatives was that the additional tax which was shown to be due as a result of the determination of invested capital and net income above mentioned was to be assessed and that the company was to submit to the Bureau at the earliest possible date, full details, prepared in the manner required by the Bureau, in support of the company's depletion claim. Such details were in due course prepared, and were submitted to the Bureau in the month of March, 1922. These details supported a claim for depletion in the sum of $1,293,198.46. The Bureau officials commenced the examination of this claim during December, 1922, but did not complete the examination (on account of various delays which arose) and reach their conclusions until July, 1923. These conclusions were that the depletion to be allowed was to be $678,496.13. The company was in due course notified of this change in depletion and that as a result there was a further tax due of $76,301.75 over the amount originally assessed. The company replied that it did not dispute the correctness of the tax due as above mentioned, but that as over five years had elapsed since the filing of the return and that as the deficiency in tax of $76,301.75 was the result of neither negligence nor fraud, the Commissioner could not under the law assess the tax.

Question:

Is the Commissioner of Internal Revenue authorized to assess the above additional tax in view of the fact that over five years had elapsed since the 1917 return was filed?

Answer:

The Commissioner is authorized to determine the amount of tax or deficiency in tax due, as the result of the final settlement of deductions tentatively allowed, and to assess and collect the same at any time, provided the taxpayer has been notified and given at least thirty days in which to file an appeal and show cause or reason why the tax should not be paid and given an opportunity for a hearing. In cases in which the additional tax due would be jeopardized by such delay the Commissioner

may make the assessment without giving such notice or awaiting the conclusion of such hearing.

REFERENCE:

Sec. 250 (d): ". . . Provided further, that in cases coming within the scope of paragraph (9)* of subdivision (a) of section 214, or of paragraph (8) * of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision. . . ."

NOTE:

Ordinarily (with only a few exceptions) the Commissioner may not assess any additional tax due on returns filed for 1921 after four years from the time of filing said returns and for subsequent years under the Revenue Act of 1921 or for prior years under the Revenue Act of 1921 or prior income tax or excess-profits tax Acts or under the Revenue Act of 1909 after five years from the time of filing said returns.

PROBLEM 256

Illustrating Case in Which a Claim in Abatement Cannot be Accepted by a Collector of Internal Revenue

FACTS:

Representatives of the Bureau of Internal Revenue made an investigation of the records of the Scranton Foundry Company to verify its income and excess-profits tax liability for the taxable years 1917 and 1918. They recommended the assessment of additional taxes amounting to $23,489.00 for 1917 and $28,560.00 for 1918. The company was notified by registered mail of the proposed additional assessment and immediately made a request for a hearing in order to show cause why the

* These paragraphs make provision for the allowance of amortization as a deduction.

additional tax should not be assessed. A hearing was granted and as a result of evidence submitted by the company the proposed additional assessment for 1917 was reduced to $13,489.00 and for 1918 to $18,560.00. The Scranton Company disagreed with the findings of the Bureau and proposed to file a claim in abatement for the entire amount assessed pending the decision by the court in a case which was being tried wherein the same point at issue was involved.

QUESTION:

Will the Collector of Internal Revenue accept a claim in abatement from the Scranton Foundry Company for the additional tax assessed for 1917 and 1918?

ANSWER:

No claim in abatement will be accepted by the Collector for any tax or deficiency in tax which has been finally determined to be due after the taxpayer has had an opportunity for a hearing.

REFERENCE:

Sec. 250 (d): ". . . If upon examination of a return made under the Revenue Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act (a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: Provided, That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing."

PROBLEM 257

Illustrating Case in Which Tax is Not Paid Upon Notice and Demand by the Collector But Amount Due is Paid Prior to Levy of Tax by Distraint and Sale of Property

FACTS:

The Moriarity Trucking Company received a registered letter from the Bureau of Internal Revenue, notifying it that additional income and excess-profits taxes of $5,000.00 were due from the company for the taxable year 1918. The company agreed that the Bureau was correct in the determination of the taxes. Sixty days later the collector sent the company a notice demanding payment of the additional tax of $5,000.00. The company, although solvent, neglected to pay the same within the ten days allowed after notice and demand by the collector. Two months after date of the notice and demand, just as the collector was about to distrain the property of the company and sell the same for the amount of the tax, the president of the company paid the amount demanded by the collector.

QUESTION:

Was the payment of $5,000.00 made by the company all that is required under the law?

ANSWER:

No, the law requires that there be added to the tax a penalty of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due. The total amount the company is obligated to pay under the law is computed as follows:

Additional assessment	$5,000.00
5% of above	250.00
Interest for two months at 1% per month on $5,000.00	100.00

Total amount due by the company	$5,350.00
Amount paid	5,000.00
Balance due	$350.00

REFERENCE:

Sec. 250 (e): "If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: . . ."

PROBLEM 258

Illustrating Case in Which Claim in Abatement May be Filed

FACTS:

The Baldwin Lighterage Company received a registered letter from the Bureau of Internal Revenue notifying it that an additional tax of $12,640.00 was due for the taxable year 1919. The company immediately filed a request for a hearing in order to present a bona fide claim for a reduction of the assessment but in less than thirty days and before the hearing had been held, the company received a notice and demand from the collector for an additional amount claimed to be due.

QUESTIONS:

1. Is the collector authorized to accept a claim for abatement for the above amount?

2. If so, what rate of interest will be charged by the collector on that part of the claim which is rejected provided the Bureau does not allow the entire claim?

ANSWERS:

1. Yes, the collector is authorized to accept a claim for abatement if filed within ten days after notice and demand of pay-

ment of tax in cases where opportunity for a hearing has not been had by taxpayer.

2. If the Commissioner rejects the claim in part, interest at the rate of one-half of 1 per centum per month from the time the amount was due until payment is made will be added thereto.

REFERENCE:

Sec. 250 (e): ". . . Provided, That as to any such amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected. . . ."

PROBLEM 259

Illustrating Case in Which Commissioner May Grant an Extension of Time for the Payment of Tax Due Where Such Payment Would Result in Undue Hardship to the Taxpayer

FACTS:

The Samato Silk Company, manufacturers of silk hosiery, had a tax assessment of $25,890 due December 15, 1921, covering the taxable year 1918. The company demonstrated to the satisfaction of the Commissioner that the payment of the above tax would entirely wipe out the working capital of the company and necessitate the closing down of its plant.

QUESTION:

Can the company obtain relief under these conditions?

ANSWER:

Yes. Under the conditions outlined above, the Commissioner may extend the time for payment of the additional tax, or any part of such tax, for a period of not over 18 months after November 23, 1921.

REFERENCES:

Sec. 250 (f): "In the case of any deficiency (except where the deficiency is due to negligence or to fraud with intent to evade

tax) where it is shown to the satisfaction of the Commissioner that the payment of such deficiency would result in undue hardships to the taxpayer, the Commissioner may, with the approval of the Secretary, extend the time for the payment of such deficiency or any part thereof for such period not in excess of eighteen months from the passage of this Act as the Commissioner may determine. In such case the Commissioner may require the taxpayer to furnish a bond with sufficient sureties conditioned upon the payment of the deficiency in accordance with the terms of the extension granted. . . ."

Sec. 250 (h): "The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act."

PROBLEM 260

Illustrating Case in Which Extension is Granted for Payment of Additional Tax Found to be Due After Examination of Return—Tax Paid Within Extension Period

FACTS:

The Royal Silk Company obtained an extension of six months from January 2, 1922, in which to pay an assessment of $45,000 covering additional taxes due for the taxable year 1918 as the result of an examination of its returns. This additional tax was not due to fraud or negligence. It paid the assessment June 29, 1922.

QUESTION:

Is the company required to pay any interest because of this extension, and if so, at what rate?

ANSWER:

Since the additional tax was not due to fraud or negligence the company would have to pay interest at the rate of ⅔ of 1% per month from January 2, 1922 to June 29, 1922 on the tax so extended.

REFERENCE:

Sec. 250 (f) provides that where the time for payment of additional tax is extended by the Commissioner ". . . There shall be

added in lieu of other interest provided by law, as a part of such deficiency, interest thereon at the rate of two-thirds of 1 per centum per month from the time such extension is granted; except where such other interest provided by law is in excess of interest at the rate of two-thirds of 1 per centum per month. . . ."

NOTE:

The provisions of this section apply to such additional taxes as are assessed under the Revenue Acts of 1917, 1918 and 1921.

PROBLEM 261

Illustrating Case in Which Extension is Granted for Payment of Additional Tax Found to be Due After Examination of Return—Payment Not Made Prior To Expiration of Extension Period

FACTS:

The Carbon Paper Supply Company received an extension of four months from February 1, 1922 in which to pay additional tax found to be due as the result of an examination of its 1917, 1918 and 1919 returns. This tax was not paid until after June 1, 1922.

QUESTION:

Is the company subject to a further penalty due to the non-payment of such tax within the extension period?

ANSWER:

When the additional tax is not paid prior to the last day of the extension period a penalty of 5% attaches, plus interest of 1% per month from the date the extension period commenced.

REFERENCE:

Sec. 250 (f) provides that where the Commissioner has granted an extension of time for the payment of additional taxes found to be due, ". . . If the deficiency or any part thereof is not paid in accordance with the terms of the extension granted, there shall be added as part of the deficiency, in lieu of other interest and penalties provided by law, the sum of 5 per centum of the deficiency and interest on the deficiency at the rate of 1 per centum per month from

the time it becomes payable in accordance with the terms of such extension."

NOTE:

This section applies on such taxes as are assessed under the Revenue Acts of 1917, 1918 and 1921.

PROBLEM 262

Illustrating Case in Which a Taxpayer Designs Quickly to Depart from the United States—The Rights of the Commissioner in Such Case

FACTS:

Roberto Santini, a resident alien who owned a retail fruit store, received a letter threatening his life if he did not deposit a thousand dollars in a certain wooden box outside of his house before midnight of December 15, 1921. Mr. Santini immediately sold his business for $4,500 and purchased a ticket for Italy on a ship sailing December 7, 1921. He had paid three installments of his income tax reported for the taxable year 1920 and the last installment of $55 was not due until December 15, 1921.

QUESTIONS:

1. Is the Commissioner authorized to require the payment of the last 1920 tax installment before the usual time it becomes due?

2. When will Mr. Santini be required to pay a tax on income received during 1921 from his business in the United States, in view of the fact that he is leaving the United States prior to the close of his taxable year?

ANSWER:

The Commissioner is authorized to demand immediate payment of the last installment of the 1920 tax, also to declare the taxable period for the year 1921 immediately terminated; and the taxes on the income for such period in 1921 shall become immediately due and payable.

REFERENCE:

Sec. 250 (g): "If the Commissioner finds that a taxpayer designs quickly to depart from the United States or to remove his property therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. . . ."

PROBLEM 263

Illustrating Case in Which a Taxpayer is about to Depart from the United States and May Not be Required to Liquidate All Taxes Due

FACTS:

Mr. Harold A. Warren, a citizen of the United States, owns a large cotton mill in New Orleans. He has arranged to take a trip to England the first week in January, 1922.

QUESTION:

Will it be necessary for the Commissioner to assess the 1921 income tax of Mr. Warren and require its payment or demand security covering the approximate amount of tax to be paid before he is allowed to sail?

ANSWER:

As Mr. Warren is a citizen of the United States the Commissioner at his discretion may waive all the requirements placed upon taxpayers departing from the United States.

REFERENCE:

Sec. 250 (g): ". . . In the case of a citizen of the United States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision."

See Problem 262 for ordinary requirements in the case of a taxpayer about to depart from the United States.

PROBLEM 264

Illustrating When Receipts for Taxes are to be Given by Collector

FACTS:

The Harbinger Oil and Gas Company issued bonds (which were rather widely distributed) containing the provision that the company agreed to pay the Federal income tax upon the interest disbursements on these bonds due by the recipients thereof (to an amount, however, not in excess of 2% of such interest). These taxes were duly paid to the collector of internal revenue by the company in 1922.

QUESTION:

Is the company entitled to receipts for the taxes thus paid?

ANSWER:

The company is entitled, upon request therefor, to a receipt for the total paid, or to separate receipts on account of each creditor for whom tax payment was made.

REFERENCE:

Sec. 251: "That every collector to whom any payment of any tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipts; and such receipt shall be suf-

ficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt."

PROBLEM 265

Illustrating Case in Which the Bureau of Internal Revenue Will Make Refund of Overpayment of Tax Without the Filing of Claim Therefor by Taxpayer

FACTS:

Mr. Andrew Logan, a citizen of the United States, received during the calendar year 1919 a salary of $10,000 and dividends (exempt from the normal tax) amounting to $65,000. In preparing his income tax return for the calendar year 1919 he computed his normal tax at the rate of 8 per cent on his entire net income after deducting the specific exemption of $1,000. (Mr. Logan is married but his wife filed a separate return for 1919 on which was claimed an exemption of $1,000.) In January 1922 Mr. Logan's 1919 return was audited and it was found he had overpaid his tax for 1919 to the extent of $5,360, as the dividends received by him were not subject to normal tax under the Revenue Act of 1918 and the first $4,000 of net income (in excess of the specific exemption) was subject to a normal tax of 4 per cent and only the excess over that amount ($5,000) was subject to a normal tax of 8 per cent. Mr. Logan had paid in full all taxes due the United States as of February 1, 1922. Mr. Logan was not aware of the fact that he had overpaid his income taxes.

QUESTION:

What procedure will the Bureau follow to adjust the above overpayment of 1919 taxes?

ANSWER:

Where an audit of a taxpayer's return reveals an overpayment

of tax, the Bureau will prepare a certificate of overassessment which is sent to the collector for the proper district, who will determine whether the overassessment should be abated, refunded or credited against assessments remaining unpaid. The collector then proceeds in the manner outlined in T. D. 3260. Any portion of the overassessment remaining after the application of such overassessment against any unpaid assessments due from the taxpayer is then refunded to the taxpayer. It should be noted that the Bureau is estopped from refunding overassessments after five years from the date when the return was filed, unless prior thereto a claim was filed therefor by the taxpayer.

References:

T. D. 3260, dated December 8, 1921, reads in part as follows:

"Reduction of internal revenue assessments and adjustments of overpayments of revenues will hereafter be accomplished in one of three ways: . . .

(b) On the basis of a certificate of overassessment prepared by the appropriate administrative unit in the Bureau in each case in which an overassessment of tax is disclosed through the audit of a return. . . . The Disbursing Clerk shall prepare disbursement checks in the amounts of the several net refundable items in favor of the respective taxpayers against whose accounts net refundable amounts shall have been allowed by the Commissioner; forward such checks, together with the certificates of overassessment (which will be transmitted to him) to the respective taxpayers; . . ."

Sec. 252: "That if, upon examination of any return of income made pursuant to this Act, the Act of August 5, 1909, entitled 'An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes,' the Act of October 3, 1913, entitled 'An Act to reduce tariff duties and to provide revenue for the Government, and for other purposes,' the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided,* That no such credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration of such five years a claim therefor is filed by the taxpayer."

PROBLEM 266

Illustrating Case in Which the Treasury Department is Required to Make Refund of or Credit for Overpayment of Tax Even Though Time Limitation Has Expired

FACTS:

The National Art Metal Company of New Jersey, organized in 1904, maintains large factories for the manufacture of metal desks, cabinets, etc.

On account of business conditions its yearly profits fluctuate considerably. As a result of these conditions the company in the good years has charged off large amounts to depreciation reserves, and in the poor years very little or none at all.

On the examination of the company's returns in 1921 by the Internal Revenue Bureau the invested capital as shown on the returns for 1917, 1918, 1919 and 1920 was decreased on account of these variations in depreciation charges, the department holding that a constant rate should have been charged throughout the entire period. The adjustments made increased and decreased the income tax for the prior years as follows:

Year	Increase	Decrease
1910		$275
1911		200
1913		290
1914		250
1915		240
1916		300
1917		300
1918	$750	
1919	675	
1920		750
	$1,425	$2,605

Income tax decreased	$2,605
" " increased	1,425
Net overpayment of income tax	$1,180

QUESTION:

Is the corporation entitled to a refund or credit on account of its overpayment of tax, even though the time limitation has expired?

ANSWER:

Yes.

REFERENCE:

Sec. 252: ". . . Provided further, That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section. . . ."

PROBLEM 267

Illustrating Case in Which Taxpayer Should File Claim For Refund of Overpayment of Tax

FACTS:

The Cloverdale Condensed Milk Company, which was organized October 1, 1920, filed an income and profits tax return for the fiscal year ending September 30, 1921, and reported a total tax of $13,677.84, which was paid in full on December 15, 1921. During the month of January, 1922, a firm of certified public accountants audited the books of the company and found that no provision had been made on the books for depreciation of

plant and equipment and that no deduction for depreciation had been claimed from taxable income on its return for the fiscal year 1921. Engineers estimated the average life of the plant and equipment to be twenty years, and the annual depreciation was arrived at on that basis. Proper adjustments were made on the books of the company to record such depreciation. The corrected amount of tax for the fiscal year 1921 as a result of the depreciation deduction was $9,377.84.

QUESTION:

What action should the company take in order to obtain a refund of the excess payment of $4,300?

ANSWER:

The company should file a claim for refund on Form 46, supported by full details with respect to the depreciation deduction which brought about the reduction in the tax.

REFERENCE:

T. D. 3260, dated December 8, 1921, reads in part as follows:

". . . (1) Reduction of internal revenue assessments and adjustments of overpayments of revenues will hereafter be accomplished in one of three ways: (a) On the basis of an application submitted by a taxpayer on Form 46, 47, or 47A, together with appropriate supporting evidence to be filed in the office of the collector of internal revenue of the district in which the tax is assessed. . . ."

PROBLEM 268

Illustrating Penalties for Failure to Pay or Collect Tax Required, or to Make a Return or to Supply Information Required

FACTS:

The Franko-Russian bank, organized under the laws of the the State of New York, did not report the amount of taxes withheld on account of interest payments made to foreign customers for the year 1920. Upon inquiry by the Treasury Department, it was discovered that this report had unintentionally not been filed.

QUESTION:

Is the bank subject to a penalty?

ANSWER:

Yes, the bank is liable to a penalty of not more than $1,000 for not reporting the information at the proper time.

REFERENCE:

Sec. 253: "That any individual, corporation, or partnership, required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times acquired under this title, shall be liable to a penalty of not more than $1,000. Any individual, corporation, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution."

PROBLEM 269

Illustrating Requirement to Make Returns of Payments of Dividends

FACTS:

The Montauk Shipbuilding Company, a corporation organized under the laws of the State of Delaware, had a very prosperous year in 1919, and paid out large dividends. Subsequently the officers of the company were requested by the Commissioner to submit a list of the stockholders and the various amounts they had received as dividends.

QUESTION:

What position can the officers take?

ANSWER:

They must comply with the request of the Commissioner of

Internal Revenue, as he is acting within the scope of the law.

REFERENCE:

Sec. 254: "That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him."

PROBLEM 270

Illustrating Returns of Brokers

FACTS:

Hardin, Cornell & Weeks is a New York Stock Exchange house. It has been called upon by the Commissioner to file a return showing therein all the transactions of a certain one of its customers for the year 1921.

QUESTION:

Must Hardin, Cornell & Weeks disclose this information?

ANSWER:

Yes, in order that the Commissioner may determine that all profits or gains, resulting from the sale or other disposition of securities, have been included on the return of a taxpayer, the Commissioner has the power under the law to request such information as that stated above from any individual, corporation or partnership doing business as a broker. Such individual, corporation or partnership is required to make a return under oath, giving the information requested.

REFERENCES:

Sec. 255: "That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will

enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid."

Art. 1065, Regulations 62: "When directed by the Commissioner, either specially or by general regulation, every person doing business as a broker shall render a return on form 1100, showing the names and addresses of customers to whom payments were made or for whom business was transacted during the calendar year or other specified period next preceding and giving the other information called for by the form."

PROBLEM 271

Illustrating Returns of Information at the Source—Payments of Salaries, etc., over $1,000

FACTS:

The Wasserman Company, organized under the laws of the State of New York, employs a great many salesmen to whom it paid salaries and commissions during 1921 in sums ranging from $4,000 to $20,000.

QUESTION:

Is the company required to make any report of these payments?

ANSWER:

Yes. It should make information returns on the proper forms on or before March 15, 1922. These returns will give (in addition to other information as required) the name and address of each individual to whom the company paid during 1921 on account of salaries and commissions as above-mentioned, amounts of $1,000 or over.

REFERENCES:

Sec. 256: "That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partnership, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1,000 or more in any taxable year, or, in the case of such payments made

by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment. . . ."

Art. 1072, Regulations 62: "The names of all employees to whom payments of $1,000 or over a year are made, whether such total sum is made up of wages, salaries, commissions, or compensation in any other form, must be reported. Heads of branch offices and subcontractors employing labor, who keep the only complete record of payments therefor, should file returns of information in regard to such payments directly with the Commissioner. When both main office and branch office have adequate records, the return should be filed by the main office. In case an employer has a large number of employees and the computation of exact amounts paid during the calendar year will result in an undue hardship, careful estimates may be made on the basis of any representative month, and unless the yearly payment based on this estimate in the case of any employee amounts to $1,000 or more, no return of payments to such employee is required."

PROBLEM 272

Illustrating Returns of Information at the Source—Payments of Interest and Dividends on Foreign Items.

FACTS:

The Rothschild Bank, organized under the laws of the State of New York, is a private banking institution dealing in foreign exchange. It also collects, for its depositors, interest that is not payable in the United States on bonds of foreign corporations and governments.

QUESTION:

Would the bank be required to report all such collections or only those over $1,000?

ANSWER:

The Commissioner may require returns with respect to all such items collected, regardless of amount.

Reference:

Sec. 256: ". . . Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks or bills of exchange. . . ."

Note:

The first paragraph of section 256, gives the requirement with respect to the filing of information returns in the case of certain payments of $1,000 or over in any taxable year. See Problem 271.

PROBLEM 273

Illustrating Availability of Returns Filed by Corporation to Stockholders Thereof

Facts:

John Rawlins owns 5% of the stock of the Long Island Foundry Company, which has paid no dividends for four years. He wants to know if the company has been prosperous and is in a position to disburse part of its surplus. He therefore desires to examine the tax returns filed by the company.

Question:

Can he have access to the returns of the company?

Answer:

Yes. All bona fide stockholders of record of a corporation owning 1% or more of its stock may examine the returns of the corporation upon request to the Commissioner. It should be noted that a severe penalty is imposed for divulging the information contained in the returns in any manner contrary to law.

REFERENCE:

Sec. 257: "That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the Secretary and approved by the President: Provided, That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: Provided further, That all bona fide stockholders of record owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both . . ."

PROBLEM 274

Illustrating the Availability of Statistics with Respect to the Operation of the Tax Laws

FACTS:

Professor Swathmore of Holyoke University, in preparing several papers for subjects he intended lecturing on, was desirous of obtaining general information with respect to the incomes of individuals and corporations in various parts of the country.

QUESTION:

Was such information available?

ANSWER:

Yes.

REFERENCE:

Sec. 258: "That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war profits and ex-

cess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable."

PROBLEM 275

Illustrating Collection of Foreign Items

FACTS:

The Swedish Bank of Christiania, Norway, opened a branch office in New York City for the purpose of carrying on a banking business for its customers who had accounts in the United States and for such other business as it might acquire by having such office. A part of such business consisted of the collection of foreign payments of interest or dividends by means of coupons, checks or bills of exchange.

QUESTION:

What procedure is necessary to comply with the income tax law?

ANSWER:

The bank should obtain a license from the Commissioner enabling it to collect foreign payments of interest or dividends by means of coupons, checks or bills of exchange. It is subject to such regulations as the Government may promulgate to enable it to obtain the information required.

REFERENCE:

Sec. 259: "That all individuals, corporations, or partnerships undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of coupons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the Government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both."

PROBLEM 276

Illustrating Taxability of Citizens of Possessions of the United States

FACTS:

Lois Cortez, a citizen of the Hawaiian Islands (but not otherwise a citizen of the United States) operates several sugar plantations on these islands. He disposes of his raw sugar to certain factors located on the Hawaiian Islands and to certain sugar refineries in California.

QUESTION:

How should he report his income?

ANSWER:

His income from sources within the United States should be reported, and the tax thereon paid under the same conditions as for a nonresident alien individual. (See Problems 159, and 161 to 166, inclusive, for illustrations.)

REFERENCE:

Sec. 260: "That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

"Nothing in this section shall be construed to alter or amend the provisions of the Act entitled, 'An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes,' approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States."

PROBLEM 277

Illustrating the Assessment of the Income Tax in Porto Rico and in the Philippine Islands

FACTS:

Mr. Almedio Lorenz, a resident citizen of Porto Rico, is prof-

itably engaged in several business ventures there. He derives all his income from sources within Porto Rico.

QUESTION:

What effect will the passage of the Revenue Act of 1921 have upon Mr. Lorenz' income-tax return for the calendar year 1921?

ANSWER:

Unless action is taken by the Porto Rican Legislature modifying the income-tax law which was in effect there at the time the 1921 Act was passed (November 23, 1921), Mr. Lorenz will make his return exactly as he would have made it if the 1921 Act had not been passed. Porto Rico has its own revenue system and laws (the income-tax law became effective June 26, 1919), and the 1921 Act specifically states that in Porto Rico the income tax shall continue to be levied, assessed, collected and paid as provided by the law prior to the passage of that Act. The Act, however, permits the Porto Rican or Philippine Legislature to amend, alter, modify, or repeal the income-tax laws in force in Porto Rico or the Philippine Islands, respectively.

REFERENCE:

Sec. 261: "That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.

"The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively."

PROBLEM 278

Illustrating the Taxability of the Income of a Citizen of the United States Residing in and Employed in a Possession of the United States

FACTS:

R. Richman is a citizen of the United States, residing in Porto Rico. He is single and has no dependents. Mr. Richman is

employed by the Porto Rican Fruit Distributing Company, and for each of the three years 1919, 1920 and 1921, had an annual net income of $18,000, as follows: $15,000 salary from the Porto Rican Company, for legal services; $2,000 interest on mortgages held in the United States; and $1,000 interest on bank deposits in the United States. Mr. Richman has no office or place of business in the United States. His salary is paid in Porto Rico.

QUESTION:

What is the income subject to tax in the United States in the calendar year 1921?

ANSWER:

$2,000. The total net income received from sources within the United States is $3,000, of which $1,000 is not taxable, as

> "interest on deposits with persons carrying on the banking business, paid to persons not engaged in business within the United States and not having an office or place of business therein"

shall not be included as gross income from sources within the United States. [Sec. 217 (a) (1) (a)]. In other words, citizens coming within the provisions of Sec. 262 must compute their income from sources within the United States in the same manner as nonresident aliens. The $15,000 salary received by Mr. Richman is not subject to the United States income tax as over 80% of Mr. Richman's gross income is derived from sources within a possession of the United States, and over 50% of his gross income is derived from the active conduct of a business within a possession of the United States.

REFERENCE:

Sec. 262: " (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States—

"(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the

close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and . . .

"(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another."

PROBLEM 279

Illustrating the Computation of the War-Profits and Excess-Profits Taxes for the Calendar Year 1921 of a Domestic Corporation Which Derives a Net Income of More than $10,000 from Government Contracts Made Between April 6, 1917, and November 11, 1918, Both Dates Inclusive

FACTS:

The Non Plus Ultra Raincoat Corporation entered into a contract with the United States Government May 1, 1917, to manufacture raincoats. During the calendar year 1921 the company derived a profit of $20,000 from this Government contract. The total net income for the year was $60,000, and the average invested capital for the taxable year $400,000. Its net income and invested capital during the years 1911, 1912 and 1913, is given in the following:

	Net income, prewar years	Invested capital, prewar years
1911	$20,000	$ 75,000
1912	10,000	100,000
1913	15,000	125,000
Total	$45,000	$300,000
Average	$15,000	$100,000

PROBLEM:

What is the excess-profits and war-profits tax liability for 1921?

SOLUTION:

Excess-profits credit

1. Eight per cent of invested capital for taxable year	$32,000
2. Specific exemption	3,000
Excess-profits credit	$35,000

War-profits credit

Average net income for prewar period	$15,000
Plus 10% of increase in invested capital ($400,000 minus $100,000 equals $300,000)	30,000
	$45,000
Specific exemption	3,000
War-profits credit	$48,000

Computation of Excess-profits tax

Bracket	Amount of net income in each bracket	Excess-profits credit	Remainder subject to tax	1921 Rates Rate	1921 Rates Amount of tax	1918 Rates Rate	1918 Rates Amount of tax
Not over 20% of invested capital	$60,000	$35,000	$25,000	20%	$5,000	30%	$7,500
Totals	$60,000	$35,000	$25,000		$5,000		$7,500

Computation of War-profits tax

Net income	$60,000	Eighty per cent of remainder of $12,000	$9,600

Less: War-profits credit	48,000			
		Less: Excess-profits tax ...	7,500	
Remainder	$12,000			
		War-profits tax		$2,100

Total war-profits and excess-profits taxes computed at 1918 rates $9,600
Total excess-profits tax computed at 1921 rates 5,000

One-third of the net income for the year was derived from Government contracts (20,000 divided by 60,000), hence

One-third of $9,600=	$3,200.00
Two-thirds of $5,000=	3,333.33
Total tax	$6,533.33

REFERENCES:

Sec. 301 (b): "For the calendar year 1921 there shall be levied, collected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

"(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such Government contract or contracts bears to the entire net income. In computing such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used;

"(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such Government contract or contracts bears to the entire net income. . ."

For further reference see Art. 713, Regulations 62.

PROBLEM 280

Illustrating Computation of Excess-Profits Tax in Case the Excess-Profits Credit is not All Absorbed in the First Bracket

FACTS:

The Soapine Chemical Corporation, which reports on the calendar-year basis, had an invested capital of $20,000 for the taxable year 1921. The net income of the company for the year was $6,000.

QUESTION:

What is the excess-profits tax?

ANSWER:

The excess-profits tax is $560, as under:

The excess-profits credit equals $3,000 plus 8% of $20,000, or a total of $4,600.

Bracket	Amount of net income in each bracket	Excess-profits credit	Remainder subject to tax	Rate	Amount of tax
Not over 20% of invested capital ...	$4,000	$4,000	—0—	20%	—0—
Over 20% of invested capital ...	2,000	600	$1,400	40%	$560
	$6,000	$4,600	$1,400		$560

REFERENCE:

Sec. 301 (c): "In any case where the full amount of the excess-profits credit is not allowed under the first bracket of subdivision (a), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket."

PROBLEM 281

Illustrating the Application of the Limitation of the Excess-Profits Tax in the Case of a Corporation Making a Return for a Full Year

FACTS:

The International Shirt Corporation had an invested capital of $25,000 for the calendar year 1921. Its income for the year ended Dec. 31, 1921, was $40,000.

QUESTION:

What is its excess-profits tax liability for 1921?

ANSWER:

The tax is $11,400, computed as follows:

Invested capital	$25,000
Net income	40,000

Excess-profits credit

Eight per cent of invested capital	$2,000
Specific exemption	3,000
Total	$5,000

Excess-profits tax

Bracket	Amount of net income in each bracket	Excess-profits credit	Remainder subject to tax	Rate	Amount of tax
Not over 20% of invested capital	$ 5,000	$5,000	—0—	20%	—0—
Over 20% of invested capital	35,000		$35,000	40%	$14,000
Total	$40,000	$5,000	$35,000		$14,000

Computation of limitation of tax

20% of ($20,000 minus $ 3,000) equals	$ 3,400
40% of ($40,000 minus $20,000) equals	8,000
Total tax	$11,400

REFERENCE:

Sec. 302: "That the tax imposed by subdivision (a) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of $3,000 and not in excess of $20,000, plus 40 per centum of the amount of the net income in excess of $20,000; . . ."

PROBLEM 282

Illustrating the Application of the Limitation of the Excess-Profits Tax in Case of a Corporation Making a Return For Less Than a Full Twelve-Months Period

FACTS:

The invested capital of the O Company for the six-months period ended Dec. 31, 1921, was $40,000. The net income for the same period was $36,000.

PROBLEM:

Compute the excess-profits tax.

SOLUTION:

Income for 6 months	$40,000
Income for 12 months, at same rate, ($^{12}/_{6}$ × $40,000)	80,000

Excess-profits credit=$3,000+8% of $40,000 or $6,200.

Bracket	Income	Credit	Balance	Rate%	Tax
1	$ 8,000	$6,200	$ 1.800	20	$ 360
2	64,000		64,000	40	25,600
	$72.000	$6,200	$65,800		$75,960
$^{6}/_{12}$ of $25,960=					$12,980

Limitation:

20% of (\$20,000 − \$ 3,000), or	\$3,400
Plus 40% of (\$36,000 − \$20,000), or	6,400
Excess-profits tax for the 6 mo. period ..	\$9,800

REFERENCES:

Articles 732 and 733, as amended by T. D. 3245, Bul. 48-21-1953.

Art. 732: "When a return is rendered for a fractional part of a year, the limitation shall be computed in the same manner as if the period covered by the return were a full taxable year."

Art. 733 contains a practical illustration of the computation.

Sec. 302 (Quoted under Problem 281)

See Problem 323.

PROBLEM 283

Illustrating the Determination of the Excess-Profits Tax in Case Thirty Percent or More of the Net Income of a Corporation Is Derived from a Trade or Business Which if It Constituted the Sole Trade or Business of the Corporation Would Bring the Corporation within the Class of Personal-Service Corporations and the Remainder of the Net Income Is Derived from a Separate Trade or Business Requiring Invested Capital

FACTS:

H. B. Thomas Engineering Company, a New York corporation, is engaged in the business of rendering professional engineering services. If this constituted its sole business, it would undoubtedly be regarded as a personal-service corporation. However, the company also owns a ten-story business building, nine floors of which it rents out to business concerns. The company itself occupies the remaining floor. The invested capital for 1921 was \$225,000, of which \$200,000 was used in the non-personal-service part of the business. The net income for the accounting year ended December 31, 1921 was \$150,000, \$60,000

of which was derived from personal services rendered and $90,000 from rentals.

QUESTION:

What is the excess-profits tax liability of the corporation for 1921?

ANSWER:

As 40% of the net income of the corporation for 1921 was derived from the personal-service part of the business of the corporation, the excess-profits tax is to be computed in accordance with the terms of section 303. The computation of such tax follows:

Excess-profits credit

Capital invested	$200,000
8% of invested capital	$ 16,000
Specific exemption (60% of $3,000)	1,800
Excess-profits credit	$ 17,800

Computation of Excess-profits Tax

Bracket	Amount of net income in each bracket	Excess-profits credit	Remainder subject to tax	Rate	Amount of tax
Not over 20% of capital invested in nonpersonal service part of business	$40,000	$17,800	$22,200	20%	$ 4,440
Over 20%	50,000		50,000	40%	20,000
	$90,000	$17,800	$72,200		$24,440

Percentage of excess-profits tax on nonpersonal-service part of business to the net income from that source is 27.156.

Therefore, the tax on the net income from the personal-service part of the business is 27.156% of $60,000, or $16,293.60.

Recapitulation of Tax

Excess-profits tax on income from nonpersonal-service part of business	$24,440.00
Excess-profits tax on income from personal-service part of business	16,293.60
Total excess-profits tax	$40,733.60

REFERENCE:

Sec. 303: "That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) which if constituting the sole trade or business would bring it within the class of 'personal service corporation,' then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in section 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: Provided, That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302."

See Art. 743, Reg. 62 for further illustration.

PROBLEM 284

Illustrating the Determination of the Excess-Profits Tax of a Corporation in 1921, in Case Part of the Income Is Derived from the Mining of Gold

FACTS:

The Tungsten-Argent Mining Company has an invested capital for the calendar year 1921, in the amount of $500,000.

The company had a net income of $200,000 for the accounting year ended December 31, 1921, of which $50,000 was derived from the mining of gold.

QUESTION:

What is the excess-profits tax liability of the corporation for 1921?

ANSWER:

The excess-profits tax is $38,550, as under:

Invested capital	$500,000
Net income	$200,000

Excess-profits credit

8% of invested capital for year	$40,000
Specific exemption	3,000
Excess-profits credit	$43,000

Computation of tax

	Bracket	Amount of net income in each bracket	Excess-profits credit	Remainder subject to tax	Rate	Amount of tax
1.	Not over 20% of invested capital	$100,000	$43,000	$57,000	20%	$11,400
2.	Over 20% of invested capital	10,000	—0—	100,000	40%	40,000
	Total	$200,000	$43,000	$157,000		$51,400

Excess-profits tax by above computation	$51,400
Proportion net income from gold mining is of total net income, 25%.	
25% of $51,400, portion of tax not to be assessed	12,850
75% of $51,400, portion of tax to be assessed	$38,550

REFERENCE:

Sec. 304: (c) "In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income."

See Art. 753, Reg. 62 for further illustration of computation.

NOTE:

The title referred to in the quotation above given both for the Revenue Act of 1921, and the Revenue Act of 1917, is that which deals with the profits tax. It is to be noted that corporations subject to excess-profits tax under the Revenue Act of 1917, and which derived income from the mining of gold are entitled to refund of the excess-profits tax paid applicable to the mining of gold.

PROBLEM 285

Illustrating Excess-Profits Credit

FACTS:

The Halomith Company, a domestic corporation, reporting on the calendar-year basis, has an invested capital for the taxable year 1921, of $200,000.

QUESTION:

What is the excess-profits credit?

ANSWER:

The excess-profits credit is $3,000 + 8% of $200,000, or $19,000.

REFERENCE:

Sec. 312: "That the excess-profits credit shall consist of a specific exemption of $3,000 plus an amount equal to 8 per centum of the invested capital for the taxable year. . . ."

PROBLEM 286

Illustrating the Specific Exemption for Excess Profits Tax Purposes Allowed to Corporations Filing a Consolidated Return

FACTS:

The Chain Lunch Room Corporation operates in 20 different States in each of which the business is carried on by a corporation organized in that State. The stock of all these companies is wholly owned by the Chain Lunch Room Corporation, which makes a consolidated return.

QUESTION:

In filing a consolidated excess profits tax return for the calendar year 1921, may the corporation take as an exemption in computing its excess-profits credit $60,000, i. e., 20 times $3,000?

ANSWER:

No. In the case of affiliated corporations making a consolidated return only one specific exemption of $3,000 is allowed.

REFERENCE:

Art. 791, Regulations 62: ". . . In the case of affiliated corporations making a consolidated return only one specific exemption of $3,000 is allowed."

PROBLEM 287

Illustrating the Computation of Invested Capital in the Case of a Corporation Holding Inadmissible Assets

FACTS:

The Taste-Well Biscuit Corporation is allowed by its charter to invest its surplus funds in securities. The following balance sheets were taken from the company's books at the beginning and end, respectively, of the taxable year 1921.

Balance Sheet as at January 1, 1921

Cash		$150,000	Accounts payable	$300,000
Accounts receivable		400,000	Bonds payable	400,000
Merchandise		300,000	Capital stock	500,000
Machinery and fixtures	$500,000		Surplus	200,000
Less: Reserve for depreciation	50,000	450,000		
N.Y. City Bonds (cost)		30,000		
U. S. Steel Corporation stock (cost)		70,000		
		$1,400,000		$1,400,000

Balance Sheet as at December 31, 1921

Cash		$200,000	Accounts payable	$150,000
Accounts receivable		300,000	Bonds payable	400,000
Merchandise		200,000	Capital stock	500,000
Machinery and fixtures	$500,000		Surplus	250,000
Less: Reserve for depreciation	100,000	400,000		
N.Y. City Bonds (cost)		30,000		
U.S. Steel Corporation stock (cost)		70,000		
City of Chicago Bonds (cost)		100,000		
		$1,300,000		$1,300,000

The City of Chicago Bonds were purchased July 1, 1921. The net income of the company for the first six months of 1921, after providing for all accrued Federal taxes, had been distributed as dividends on that day. Except for the adjustment necessary on account of inadmissible assets, the capital stock and surplus as shown by the January 1, balance sheet, represent the invested capital for 1921.

QUESTION:

What is the invested capital of the corporation for 1921?

ANSWER:

The invested capital is $622,222.22 as under:

Capital stock			$500,000
Surplus			200,000
Total			$700,000
Less adjustments for inadmissible assets as under:			
(a) Amount of inadmissible assets Jan. 1, 1921			
N. Y. City Bonds	$30,000		
U. S. Steel Corp. Stk.	70,000		
Total		$100,000	
(b) Amount of inadmissible assets Dec. 31, 1921			
N. Y. City Bonds	$30,000		
U. S. Steel Corp. Stk.	70,000		
City of Chicago Bonds	100,000	200,000	
		$300,000	
(c) Average inadmissible for year		150,000	
(d) Amount of admissible assets Jan. 1, 1921 ($1,400,000 total assets less $100,000 inadmissible)		$1,300,000	

(e)	Amount of admissible assets Dec. 31, 1921 ($1,300,000 total assets less $200,-000 inadmissible)	1,100.000	
(f)	Average admissibles for year $1,200,000		
(g)	Sum of (c) and (f) $1,350,000		
(h)	Percentage which (c) is of (g)	11⅑%	
	11⅑% of $700,000—(invested capital before adjustment for inadmissibles		77,777.78
	Adjusted invested capital		$622,222.22

NOTE:

It will be observed from the balance sheet that the reserve for depreciation is taken off the asset rather than allowing it to remain as a liability. Each item on the balance sheet must be evaluated in accordance with the statute prior to the determination of the total admissible or inadmissible assets.

REFERENCES:

Sec. 325 (a) " . . . The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, . . .

"The term 'admissible assets' means all assets other than inadmissible assets, valued in accordance with the provisions of subdivision (a) of section 326 and section 331."

Sec. 326 (c): "There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year."

PROBLEM 288

Illustrating the Method of Computing the Amount of Inadmissible Assets Which Becomes Admissible in Case Income Derived from Such Assets Consists in Part of Gain or Profit Derived from Sale or Other Disposition Thereof or in Case All or Part of the Interest Derived from Such Assets is in Effect Included in the Net Income Because of the Limitation on the Deduction of Interest Under Paragraph (2) of Subdivision (a) of Section 234

FACTS:

The Manly Phonograph Corporation owns one-third of the $300,000 par value outstanding of the Everlasting Phonograph Motor Corporation stock. The Manly Company also owns $200,000 of the $500,000 par value of the outstanding capital stock of the Ajax Phonograph Corporation. In 1921, the Manly Phonograph Corporation received dividends in the amount of $6,000 from the Everlasting Phonograph Motor Corporation, and $12,000 from the Ajax Phonograph Corporation. On July 1, 1921, the Manly Phonograph Corporation sold its Ajax Phonograph Corporation stock at a profit of $12,000. The dividends received both from the Everlasting Phonograph Motor Corporation and from the Ajax Phonograph Corporation, are not includable in taxable net income. The Manly Phonograph files its return on the calendar-year basis.

QUESTION:

How much of the inadmissible assets become admissible, and for what period?

ANSWER:

$100,000 of Ajax Phonograph Corporation's stock becomes admissible for the period from January 1, 1921, to June 30, 1921, and is computed as shown in the following:

Income from dividends	$12,000
" " sale of stock	12,000
Total	$24,000

Income from sale of stock equals 50% of total income from the same class of stock; hence 50% of $200,000, or $100,000, of Ajax Phonograph Corporation stock becomes admissible up to the date sold.

REFERENCE:

Sec. 325 (a): ". . . The term 'inadmissible assets' means stocks, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income, but where the income derived from such assets consists in part of gain or profit derived from the sale or other disposition thereof, or where all or part of the interest derived from such assets is in effect included in the net income because of the limitation on the deduction of interest under paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets; . . ."

See also Art. 817, Reg. 62.

PROBLEM 289

Illustrating Contract Considered as Intangible Property in Connection with Computation of Invested Capital

FACTS:

The Amos Realty Construction Corporation was organized with $100,000, capital stock. The company issued $20,000 of its capital stock for a contract to construct a business building, which contract has been obtained by one of the company's organizers. No part of the contract has been performed.

QUESTION:

Is this contract to be considered tangible property, or is it intangible?

ANSWER:

It is considered intangible property. While the contract relates to tangible property, its value, if any, arises not from that fact but from the expectation of a realization of profit upon the performance of the contract, and is, therefore, under the Bureau's interpretation, regarded as intangible property.

REFERENCES:

Bul. 33–20–1140; O. D. 635: ". . . Held, that an unperformed contract to furnish manufactured products represents no rights in tangible property which would entitle it to be regarded as deriving its value chiefly therefrom. On the contrary, the value of the contract is of an intangible nature, contingent upon the performance of its terms and the realization of the anticipated profit. The intangible rights under such a contract would, therefore, be subject to the limitation contained in section 207 of the Revenue Act of 1917, and section 326 of the Revenue Act of 1918, in the case of intangible property purchased with corporate stock. . . ."

Art. 811, Regulations 62: ". . . Most contracts are intangible property and in the absence of a specific ruling by the Commissioner to the contrary should be so regarded for the purpose of making returns. A contract may be treated as tangible property only after the submission of a full statement as to its exact nature, showing to the satisfaction of the Commissioner that it relates to rights in tangible property to such an extent that its value arises chiefly therefrom . . ."

Sec. 325 (a): "That as used in this title—The term 'intangible property' means patents, copyrights, secret processes and formulae good will, trade-marks, trade-brands, franchises and other like property; . . ."

PROBLEM 290

Illustrating Inadmissible Assets—Federal Reserve Bank Stock

FACTS:

The Industrial Commercial Bank, which is a member of the Federal Reserve Bank, owns $40,000 par value of Federal Reserve Bank stock, acquired in 1919.

QUESTION:

Is this stock to be treated as an admissible or inadmissible asset in the computation of invested capital for 1921?

ANSWER:

It is to be treated as an inadmissible asset.

REFERENCE:

Bul. 1–19–118; O. 781: "Federal reserve bank stock held by member banks is held to be an inadmissible asset in determining invested capital for excess-profits tax purposes."

PROBLEM 291

Illustrating War Finance Corporation Bonds as Inadmissible Assets

FACTS:

The Fragrant Tea Corporation invested $10,000 in War Finance Corporation bonds.

QUESTION:

Are these bonds inadmissible assets for purposes of determining the 1921 invested capital?

ANSWER:

Since interest on these bonds up to $5,000 principal amount is exempt from taxation, the principal up to that amount is inadmissible. In this case $5,000 is inadmissible and $5,000 admissible.

REFERENCES:

Bul. 1-19-116; O. 781 (as per Digest of Income Tax Rulings): "Interest on an amount of bonds of the War Finance Corporation, the principal of which does not exceed in the aggregate $5,000, is exempt from Federal income and excess profits taxes. Corporate funds invested in such bonds are inadmissible assets to the extent that they are invested in bonds of a face value of not more than $5,000, but funds of a corporation or an association invested in such bonds are admissible assets so far as they are invested in such bonds beyond a principal or face value of $5,000."

Sec. 325 (a): "That as used in this title— . . . The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income. . . ."

PROBLEM 292

Illustrating Inadmissible Assets—Stock of Foreign Corporations

FACTS:

The Oriental Goods Trading Company, a domestic corporation, during the entire calendar year 1921, owned 10% of the capital stock of the China Trading Company (a foreign corporation). The China Trading Company, organized in 1920, for the entire period since the date of its organizaton to the close of 1921 derived 90% of its gross income from sources within the United States. The Oriental Goods Trading Company filed its 1921 return on the calendar-year basis and was subject to the excess-profits tax.

QUESTION:

Is the stock of the China Trading Company to be treated as an admissible or an inadmissible asset?

ANSWER:

It is to be treated as an inadmissible asset as the dividends receivable by the domestic corporation from the foreign corporation are deductible in the computation of net income subject to tax.

REFERENCES:

Sec. 325 (a): "That as used in this title . . . The term 'inadmissible assets' means stocks, bonds and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income. . . ."

Sec. 234 (a) (6) (Quoted under Problem 217)

PROBLEM 293

Illustrating Capital Stock Which May be Included as An Admissible Asset

FACTS:

The Chair Carving Corporation of Massachusetts, owns stock

in the Chair Carving Corporation of England, which has no income from sources within the United States.

QUESTION:

Does this stock constitute an admissible asset in the hands of the Massachusetts corporation?

ANSWER:

Yes, as the dividends thereon are taxable.

REFERENCES:

Sec. 325 (a): "That as used in this title— . . . The term 'inadmissible assets' means stocks, bonds, and other obligations (other than obligations of the United States), the dividends or interest from which is not included in computing net income. . . . The term 'admissible assets' means all assets other than inadmissible assets."

Bul. 22-19-538; T. B. R. 67 (as given in the Digest of Income Tax Ruling): "Where a domestic corporation exchanges patent rights and cash for stock in a foreign corporation which derives no income from sources within the United States, the shares of stock so received are admissible assets in determining the invested capital of the domestic corporation. . . ."

PROBLEM 294

Illustrating the Determination of the Value for Invested Capital Purposes of Stock or Shares Issued at a Nominal Value or Having No Par Value

FACTS:

The Truesdale Timber Corporation was organized in 1898 to hold certain lands, and cut and sell the timber therefrom. The company paid all its capital stock of 1000 shares of no par value for this land, which consisted of approximately 200 acres. Sales of neighboring property at about the time of this transaction indicated that the land acquired by the corporation for its stock was unquestionably worth $20 an acre. There were no sales of stock itself, on which its value could be based.

QUESTION:

At what value may the capital stock be included in invested capital?

ANSWER:

Four thousand dollars, i. e., based upon the value of the property paid in for such stock, the actual value of such stock at the date of issue.

REFERENCE:

Sec. 325 (b): "For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares."

PROBLEM 295

Illustrating the Computation of Invested Capital—Capital Stock and Surplus

FACTS:

The balance sheet of the Strong Furniture Company on January 1, 1921, appeared as follows:

ASSETS		LIABILITIES	
Cash	$10,000	Accounts payable	$30,000
Accounts receivable	25,000	Capital stock	25,000
Merchandise	50,000	Surplus	40,000
Other assets (tangible)	10,000		
	$95,000		$95,000

The capital stock had all been issued January 1, 1914, for cash at par. The surplus account reflected only actual earned surplus. None of the asset accounts had been adjusted above or below cost, except for depreciation sustained. There were no changes in invested capital during 1921. The company reports on a calendar year basis.

QUESTION:

What is the invested capital of the company for 1921?

ANSWER:

The invested capital is \$65,000 and is computed as follows:

Capital stock	\$25,000
Surplus	40,000
Total	\$65,000

REFERENCE:

Sec. 326 (a): "That as used in this title the term 'invested capital' for any year means (except as provided in subdivisions (b) and (c) of this section): (1) Actual cash bona fide paid in for stock or shares; . . . (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year;"

PROBLEM 296

Illustrating the Determination of Invested Capital in Case Capital Stock Was Issued Originally at a Premium or at Par and is Bought Back at a Lower Premium or at a Discount

FACTS:

The Curtis Candy Manufacturing Corporation in 1915, sold to a Mr. Herbert \$20,000 par value of its original issue of capital stock for \$25,000 cash. Mr. Herbert in 1920 sold his stock back to the corporation for \$15,000.

QUESTION:

At what amount can this stock of \$20,000 par value be included in the invested capital of the company for the calendar year 1921?

ANSWER:

The capital stock itself, being Treasury Stock, can not be included in invested capital. However, the excess of the amount for which the stock was originally issued over the amount for which it was repurchased is considered capital if that amount has remained undistributed.

Mr. Herbert paid in $25,000 to the corporation but later withdrew only $15,000. He therefore permitted $10,000 to remain in the business, which becomes capital.

References:
Sec. 326 (a) (1) (Quoted under Problem 295)
For further reference see Articles 543, 563 and 862, Regulations 862.

PROBLEM 297

Illustrating Paid-in Surplus

Facts:

The Free Run Salt Company, a partnership, reorganized as a corporation December 31, 1916, and turned over all its assets and liabilities to the corporation for the latter's entire capital stock of $50,000. The certified balance sheet of the partnership as of the date of transfer follows:

Balance Sheet as at December 31, 1916.

ASSETS		LIABILITIES AND CAPITAL	
Cash	$20,000	Accounts payable	$20,000
Accounts receivable	25,000	Proprietorship	80,000
Merchandise	20,000		
Building	30,000		
Furniture, Autos	5,000		
	$100,000		$100,000

The assets above listed are shown at their actual cash value on December 31, 1916.

Question:

What is the paid-in surplus of the corporation?

Answer:

$30,000. The net value of the business which was turned over intact to the corporation for $50,000 capital stock was

$80,000. Therefore the corporation has a paid-in surplus of $30,000. This paid-in surplus constitutes a part of the corporation's invested capital as long as such paid-in surplus remains undistributed.

REFERENCE:

Sec. 326 (a) " . . . the term 'invested capital' for any year means . . . (2) Actual cash value of tangible property, other than cash, bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original stock or shares specifically issued therefor, unless the actual cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus. . . . (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year; . . ."

PROBLEM 298

Illustrating Appreciation in Value of Property Which Appreciation Cannot be Included in Invested Capital

FACTS:

The Grace Mining Corporation was organized in 1915 and took over a group of mining properties for which it issued $5,000,000 par value of its capital stock. At the time it took over these properties the actual value of the properties was $5,000,000. As a result of the discovery of oil in 1919 on one of its properties, the value materially increased, and after an appraisal as of December 31, 1920, the increased value was entered in the books, surplus being credited in the amount of $1,000,000.

QUESTION:

Is this increase in value of the property to be included in the invested capital for the calendar year 1921?

ANSWER:

No.

REFERENCE:

Sec. 326 (a) (Quoted under Problem 297)

PROBLEM 299

Illustrating the Inclusion in Invested Capital of Stock Distributed to Employees for Services Rendered

FACTS:

The Mauly Trading Corporation decided in 1920 that at the end of the year it would pay as additional compensation to its employees 10% of their annual wages, in the form of stock of the corporation at par. The annual wages amounted to $50,000. Accordingly, on December 31, 1920, $5,000 par value capital stock was issued to the employees as additional salary. The services were considered worth $4,000, which was the market value of the stock when distributed to the employees.

QUESTION:

May this $5,000 capital stock be included in invested capital for the year beginning January 1, 1921, and if so, at what amount?

ANSWER:

Yes, it may be included as invested capital at $4,000 which represents the cash value of the services rendered.

REFERENCE:

Bul. 13-19-431; O. D. 248: "Shares of stock distributed by a corporation to its employees in payment of services rendered, where the amount is not excessive, may be included in invested capital to the extent of the actual cash value of the services rendered."

PROBLEM 300

Illustrating Inclusion in Invested Capital of Commissions Paid For the Sale of the Capital Stock of a Corporation

FACTS:

The Economical Auto Company sold its capital stock of

$200,000 through a syndicate, the syndicate charging 2% commission, or $4,000, the corporation receiving $196,000 in cash.

QUESTION:

At what amount is the capital stock to be included in invested capital?

ANSWER:

The amount to be included in invested capital is $200,000. Since the $4,000 partakes of an organization or underwriting expense it cannot be charged off to income but must be capitalized.

REFERENCE:

Bul. 11–19–391; T. B. R. 40: "The opinion of the Advisory Tax Board has been asked as to whether commissions paid by a corporation for the sale of its capital stock are to be deducted in computing invested capital. Upon this question section 326 (a) states that invested capital means (1) 'Actual cash bona fide paid in for stock or shares.' . . . These words signify the actual cash paid in to the corporation or to its duly authorized agents by the shareholders. Moreover, the treatment of this question and that of the deductibility of such commissions from gross income as ordinary and necessary expenses should be correlative. Under all Federal income tax laws corporations have been denied the right to deduct such commissions either as current expense or as a deferred charge to future years. As it is a fact that such commissions are "ordinarily" paid—and in the organization of many corporations "necessarily" paid—the position of the department with respect to the deductibility from income of this expense can rest only on the ground that it is essentially a capital expenditure, balanced by the acquisition of a permanent capital asset of equivalent worth.

. . . Such payments must, however, like other compensation for personal service, be 'reasonable' in amount. The payment of any unusual or disproportionate commission should, in the opinion of the Advisory Tax Board, be examined for the purpose of ascertaining whether the cash subscription has been 'bona fide paid in' and whether under the circumstances of the particular case the commission was reasonable."

PROBLEM 301

Illustration of Borrowed Capital for Purposes of Invested Capital

FACTS:

The Porter Glass Corporation from time to time needed cash, as its money was largely tied up in accounts receivable and merchandise. As cash was needed the corporation would hypothecate its accounts receivable, upon which a friendly bank would advance the funds required by the corporation. On January 1, 1921, the beginning of the corporation's accounting year, the balance sheet showed accounts payable of $100,000 to the bank.

QUESTION:

Is this sum a part of the corporation's invested capital for 1921?

ANSWER:

No. Borrowed money is not a part of invested capital.

REFERENCE:

Sec. 326 (b): "As used in this title the term 'invested capital' does not include borrowed capital."

PROBLEM 302

Illustrating Borrowed Capital Not to be Included in Invested Capital—Debenture Bonds

FACTS:

The Square Deal Trucking Corporation was organized in 1901. It issued at the time of organization for purposes of having working capital, $150,000 of Gold Debenture Bonds to run for fifty years at 6% interest. The payment of both interest and principal on these bonds ranks with the interest of general creditors.

QUESTION:

May these bonds be considered as preferred stock and be included in invested capital for 1921?

ANSWER:

No. These bonds unquestionably represent borrowed capital, which is expressly under the statute excluded from invested capital.

REFERENCES:

Sec. 325 (a): "That as used in this title . . . The term 'borrowed capital' means money or other property borrowed, whether represented by bonds, notes, open accounts, or otherwise. . . ."

Sec. 326 (b) (Quoted under Problem 301)

Art. 812, Regulations 62: "Any interest in a corporation represented by bonds, debentures, or other securities, by whatever name called, if with respect to the payment of either interest or principal it ranks with or prior to the interest of the general creditors, is borrowed capital and cannot be included in computing invested capital."

PROBLEM 303

Illustrating Borrowed Capital Which May be Included in Invested Capital—Indebtedness to Stockholders Cancelled

FACTS:

The Marble Slab Corporation owed its president the sum of $50,00C, which represented unpaid salary for 1918, 1919 and 1920. Owing to poor business conditions the corporation could not pay this debt without serious impairment of its financial condition. The president, who owned most of the company's stock, on December 31, 1920, decided to forgive this debt and notified the corporation to that effect.

QUESTION:

May the corporation consider this $50,000 as invested capital for its accounting year ended December 31, 1921?

ANSWER:

Yes, the indebtedness thus cancelled becomes paid-in surplus.

REFERENCES:

Sec. 326 (a): "That as used in this title the term 'invested capital' for any year means: . . . (3) Paid-in or earned surplus and undivided profits; not including surplus and undivided profits earned during the year; . . ."

Art. 813, Regulations 62: "Whether a given amount paid into or left in the business of a corporation constitutes borrowed capital or paid-in surplus is a question of fact. Thus, indebtedness to stockholders cancelled and left in the business would ordinarily constitute paid-in surplus, while amounts left in the business representing salaries of officers in excess of their actual withdrawals, or deposit accounts in favor of partners in a partnership succeeded by the corporation, will be considered paid-in surplus or borrowed capital according to the facts of the particular case. The general principle is that if interest is paid or is to be paid on any such amount, or if the stockholder's or officer's right to repayment of such amount ranks with or before that of the general creditors, the amount so left with the corporation must be considered as borrowed capital and be so treated in computing invested capital."

PROBLEM 304

Illustrating Case in Which Evidences of Indebtedness May be Included in Invested Capital

FACTS:

The Fernald Fine Chair Company was organized in February, 1919, under the laws of a State which permits the issue of capital stock for promissory notes. The organizers paid for their stock $50,000 in cash and $50,000 in promissory notes bearing interest at the rate of 6% and payable in five years. These notes were all enforcible and were received by the corporation in absolute payment of the stock. The makers of the notes were persons of financial responsibility.

QUESTION:

May these notes be considered as invested capital?

ANSWER:

Yes. These notes constitute tangible property paid in.

REFERENCES:

Sec. 325 (a): "That as used in this title—The term 'tangible

property' means stocks, bonds, notes, and other evidences of indebtedness, bills and accounts receivable, leaseholds, and other property other than intangible property; . . ."

Sec. 326 (a) (2) (Quoted under Problem 297)

Art. 833, Regulations 62: *"Tangible property paid in: evidences of indebtedness*— Enforcible notes or other evidences of indebtedness, either interest-bearing or noninterest-bearing, of the subscriber received by a corporation upon a subscription for stock may be considered as tangible property in computing its invested capital to the extent of the actual cash value of such notes or other evidences of indebtedness at the time when paid in, but only (a) if such notes or evidences of indebtedness could under the laws of the jurisdiction in which the corporation was organized legally be received in payment for stock, and (b) if they were actually received by the corporation as absolute, and not as conditional, payment in whole or in part of the stock subscription."

PROBLEM 305

Illustrating the Restoration to Invested Capital of Amounts Written Off in Prior Years Against Tangible Property

FACTS:

The Safety Banking Corporation in 1915, for purposes of conservatism, wrote down its banking establishment (building, furniture and fixtures) to $1.00. The amount of $499,999 was written off by a charge against surplus.

QUESTION:

May the amount written off be restored to invested capital for 1921?

ANSWER:

The $499,999 less depreciation sustained may be restored to invested capital.

REFERENCES:

Art. 838, Regulations 62: "Only true earned surplus and undivided profits can be included in the computation of invested capital, and if for any reason the books do not properly reflect the true surplus such adjustments must be made as are necessary in order to arrive at the correct amount. . . ."

Art. 840 Regulations 62: "A corporation's books of account will be presumed to show the facts. If it claims that its capital or

surplus account is understated the burden of proof will rest upon it. Additions to such accounts will be accepted to the following extent: . . .

"Amounts which have been expended before January 1, 1917, for the acquisition of plant, equipment, tools, patterns, furniture, fixtures, or like tangible property, having a useful life extending substantially beyond the year in which the expenditure was made, and which have been charged as current expense, may (less proper deductions for depreciation or obsolescence) be added to the surplus account when such assets are still owned and in active use by the corporation during the taxable year. . . ."

PROBLEM 306

Illustrating the Restoration to Invested Capital of Amounts Written off in Prior Years Against Intangible Property

FACTS:

The Tinker Tin Canning Corporation when it organized in 1894, issued $50,000 of its total of $100,000 capital stock for good will, equal in value to the par of the stock issued for it. The corporation in 1910, charged the good will off to surplus.

QUESTION:

May this good will be restored to invested capital for 1921?

ANSWER:

Yes, subject of course to the limitations set forth for intangible property acquired with capital stock.

REFERENCE:

Sec. 326 (a) (4) (Quoted under Problem 308)

Art. 840 (3) Regulations 62: "Amounts which have been expended in the past for intangible property of any kind can be restored to capital or surplus account only to the extent that the corporation specifically paid such amounts for the intangible property as such . . ."

PROBLEM 307

Illustrating Computation of Invested Capital in Case Intangible Property Has Been Paid in for Stock or Shares Prior to March 3, 1917

FACTS: (Case A)

The Tobacco Process Corporation was organized January 2, 1917, with capital stock of $150,000, of which $100,000 was issued for cash and $50,000 was issued to H. Hernandy for a secret process for curing tobacco. Mr. Hernandy had been offered about the time of the incorporation, $75,000 in cash for the secret process by an old established firm, but turned this offer down in order to become a stockholder in the Tobacco Process Corporation of which he was one of the organizers. The surplus as of the beginning of the taxable year 1921, was $50,000. Capital stock remained unchanged. No adjustments of invested capital are necessary except for the intangibles acquired for capital stock. The secret process was carried on the books at $50,000.

QUESTION:

What is the invested capital?

ANSWER:

The invested capital is $187,500.00, and is computed as follows:

Capital stock		$150,000
Surplus		50,000
Total		$200,000
Less: Adjustment for intangible property (secret process):		
Amount at which carried on books,	$50,000	
Less: 25% of $150,000 capital stock outstanding March 3, 1917, and on		

the first day of the taxable year ...	37,500	12,500
Invested capital		$187,500

NOTE:

The 25% limitation in this case is lower than the cash value of the intangibles when acquired, and is also lower than the par value of the stock issued for the intangibles, and is therefore the one which applies.

FACTS: (Case B)

Assume that at the time the Tobacco Process Corporation was organized, the cash value of Mr. Hernandy's secret process had been $30,000 instead of $75,000 as in Case "A."

QUESTION:

What would the invested capital have been?

ANSWER:

The invested capital would have been $180,000, as under:

Capital stock		$150,000
Surplus		50,000
Total		$200,000
Less: Adjustment for intangibles:		
Book value	$50,000	
Less: Cash value allowed	30,000	20,000
Invested Capital		$180,000

The lowest value here is the cash value, and therefore the cash value is the one which applies.

FACTS: (Case C)

Assume the facts to be the same as in Case "A" above, except that Mr. Hernandy accepted $25,000 in stock for his secret process, the remainder of the stock being paid in cash, $175,000. In this case the process is carried on the books at $25,000.

QUESTION:

What is the invested capital?

ANSWER:

The invested capital is $200,000 as under:

Capital stock	$150,000
Surplus	50,000
	$200,000
Less: Adjustment for intangibles	none
Invested capital	$200,000

The lowest value here is the par value of the stock paid for the intangible property ($25,000), and therefore no change is made.

REFERENCE:

Sec. 326 (a) (4) and (5) (Quoted under Problem 308)

PROBLEM 308

Illustrating the Computation of Invested Capital in Case of Intangible Property Acquired for Stock or Shares Before March 3, 1917—Par Value of Capital Stock Outstanding on First Day of Taxable Year Less Than Amount Outstanding March 3, 1917

FACTS:

The North American Pencil Corporation was organized February 1, 1917, with a capital stock of $200,000. The corporation purchased the going business of J. M. Sharp for $100,000 par value of stock. The assets acquired consisted of plant and equipment of a cash value of $80,000 and goodwill of a cash value of $50,000. The liabilities assumed amounted to $30,000. The remainder of the capital stock was issued for cash at par. During 1919 the capital stock was reduced to $100,000, the balance being retired at par. On January 1, 1921, the capital stock outstanding was $100,000, and surplus $25,000. Except

for the adjustment necessary on account of the goodwill, which was carried on the books at $50,000, the capital stock and surplus of the company on January 1, 1921, represented the company's invested capital for 1921.

QUESTION:

What is the invested capital for 1921?

ANSWER:

The invested capital is $100,000, as under:

Capital stock		$100,000
Surplus		25,000
		$125,000
Less: Adjustment for intangibles (goodwill)		
Book value	$50,000	
Less 25% of $100,000 capital stock outstanding January 1, 1921	25,000	25,000
Invested capital		$100,000

REFERENCE:

Sec. 326 (a): "That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section): . . . (4) Intangible property bona fide paid in for stock or shares prior to March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest; (5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: Provided, That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; . . ."

PROBLEM 309

Illustrating Computation of Invested Capital in Case Intangible Property has been Paid in for Stock or Shares After March 3, 1917

FACTS: (Case A)

The Electron Separator Corporation was organized June 3, 1919, for the purpose of separating metals by a patented process. The company had a capital stock of $200,000, par value, of which $100,000 was issued for cash to Aaron Straus at par, $40,000 to Richard Goodnow for tangible property, and $60,000 to Eldridge Corey for the separation patent. The capital stock was unchanged at January 1, 1921, and the surplus at that time as shown by the balance sheet was $20,000. Just prior to the company's taking over the patent the previous owner had been offered $100,000 for his patent. The patent was carried on the books at the par value of the stock issued therefor. Except for the adjustments necessary on account of the issue of stock for an intangible, the capital stock and surplus of the company January 1, 1921, represented its invested capital for 1921.

QUESTION:

What is the invested capital of the company for 1921?

ANSWER:

The invested capital is $210,000, as under:

Capital stock		$200,000
Surplus		20,000
Total		$220,000
Less: Adjustment for intangible (patent)		
Book value	$60,000	
25% of capital stock allowed	50,000	10,000
Invested capital		$210,000

The 25% limitation is lower than the cash value of the intangible when acquired, and is also lower than the par value of the stock issued for the intangible, and therefore applies in this instance.

FACTS: (Case B)

Assume the same facts to obtain as in Case "A" except that the cash value of the patent at the time of organization was $40,000.

QUESTION:

What is the invested capital for 1921?

ANSWER:

The invested capital is $200,000, as under:

Capital stock		$200,000
Surplus		20,000
Total		$220,000
Less: Adjustment for intangible (patent)		
Book value	$60,000	
Cash " when acquired	40,000	20,000
Invested capital		$200,000

The cash value is the lowest of the limitations, and therefore applies in this instance:

FACTS: (Case C)

Assume same facts to obtain as in Case "A" except that the par value of the stock issued for the patent was $35,000, and the total outstanding stock, therefore, $175,000.

QUESTION:

What is the invested capital?

ANSWER:

The invested capital is $195,000 as under:

Capital stock	$175,000
Surplus	20,000
Total	$195,000
Less: Adjustment for intangible	None
Invested capital	$195,000

The par value of the stock issued for the patent is the lowest of the limitations and therefore applies in this instance. Since the patent is carried on the books at the par value of the stock issued therefor, no adjustment is necessary.

REFERENCE:

Sec. 326 (a) (5) (Quoted under Problem 308)

PROBLEM 310

Illustrating Case in Which Leasehold May Not be Included in Invested Capital

FACTS:

The Brown Theatre Corporation, organized in 1900, obtained in 1914 without cost an original lease for 100 years on a theatre building. On December 31, 1920, this leasehold had a value of $50,000, and the corporation wrote this value into its books on that date and credited paid-in surplus. Returns are filed on the calendar-year basis.

QUESTION:

Can this leasehold be included in the invested capital for 1921?

ANSWER:

No. Appreciated values cannot be included in invested capital.

REFERENCE:

Bul. 19-20-925; A. R. R. 86:

"Held, . . . that a claim for paid-in surplus . . . can not be allowed in the case of appreciated value in a leasehold which was acquired by the company as original lessee without cost and which was not paid in at a fixed value for stock or shares."

PROBLEM 311

Illustrating Determination of Invested Capital in Case Bondholders Purchase at Foreclosure Sale the Property Covered by the Mortgage Securing the Bonds and Then Transfer said Property to a New Corporation in Exchange for its Capital Stock

FACTS:

The Logan Local Transport Company had outstanding $1,500,000 in bonds. In 1900 it could not meet its interest payments. Under foreclosure proceedings the bondholders bought for $600,000 the property covered by the mortgage, and exchanged the property for the entire stock in a new corporation. The property was at that time worth $1,000,000.

QUESTION:

Disregarding depreciation, at what amount may this property be taken into invested capital?

ANSWER:

$1,000,000, as this was the value of the property paid in for the stock at the time of payment.

REFERENCE:

Bul. 8-19-334; T. B. R. 32 (as given in the Digest of Income Tax Rulings): "Where bondholders purchase at foreclosure sale the property covered by the mortgage securing the bonds and form a new corporation to which the property is transferred in exchange for its entire capital stock, the corporation should be allowed to set up an invested capital equal to the value of the property transferred to the corporation as of the date of transfer, such value to be established by evidence acceptable to the Commissioner."

PROBLEM 312

Illustrating Computation of Invested Capital—Fair Market Value of Assets as of March 1, 1913 has no Bearing on Invested Capital

FACTS:

The Chamberlain Piano Corporation for income tax purposes valued its buildings at $150,000, or $50,000 more than cost, $150,000 being the March 1, 1913, value of the buildings. The company depreciated its buildings on this basis.

QUESTION:

May the March 1, 1913, value appreciation be included in invested capital?

ANSWER:

No, unless this appreciation has been realized prior to the beginning of the taxable year. The March 1, 1913, value cannot be used for invested capital, as it represents an appreciation of value which is not allowed under the law.

REFERENCES:

Art. 831, Regulations 62: ". . . The fair market value of the assets as of March 1, 1913, has no hearing on invested capital."

Art. 1561, Regulations 62: ". . . The fair market value as of March 1, 1913, has no bearing on the determination of the invested capital of a corporation for the purpose of the war-profits and excess-profits tax."

PROBLEM 313

Illustrating the Computation of Invested Capital—Bonus Stock

FACTS:

The Patent Fuel Corporation, needing additional funds, issued $100,000 Debenture Bonds on December 31, 1920, maturing in fifty years and bearing 6% interest. An underwriting

syndicate offered to take the whole issue in $1000 denominations at 950, or to take the whole issue at par if it received with every $1,000 share one share of the common capital stock of the corporation. This second offer was accepted and the exchange was accordingly made.

QUESTION:

At what amount, if any, may this bonus stock be included in the invested capital of the Patent Fuel Corporation?

ANSWER:

At $5,000. One hundred shares of stock were issued for which $50 per share was received in excess of what would have been received for the bonds alone.

REFERENCE:

Art. 832, Regulations 62: "Capital stock issued as a bonus in connection with the sale of a corporation's bonds may not be included in invested capital unless the corporation proves to the satisfaction of the Commissioner that such stock bonus enabled the corporation to secure a higher price for the bonds than it could otherwise have secured. Wherever this fact is established such stock shall be included in computing invested capital to the extent of the difference between the selling price of the bonds and the price at which they could have been sold if issued without such stock bonus. . . ."

PROBLEM 314

Illustrating the Determination of the Amount of Capital Stock Paid for Intangibles in Case a Mixed Aggregate of Tangible and Intangible Property has been Acquired by the Issue of Stocks and Bonds

FACTS:

The Latest Fiction Magazine, Inc., was organized April 5, 1916, to take over the business and assets of the Fairview Magazine, Inc., which it succeeded. The tangible property acquired was valued at $4,000,000 while the intangible property acquired was valued at $1,000,000. For this entire property The Latest

Fiction Magazine, Inc., issued $2,000,000 par value of its capital stock and $3,000,000 par value of its first-mortgage 6% bonds.

QUESTION:

What is the amount of the good will acquired for capital stock and what amount, if any, was acquired for bonds?

ANSWER:

The entire $1,000,000 worth of good will was acquired for stock. Applying $3,000,000 of the bonds against the $4,000,000 tangible assets leaves $1,000,000 tangible property as having been acquired with stock. The balance of the stock, that is, $1,000,000, is considered as having been issued for good will.

REFERENCES:

Art. 835, Regulations 62: *"Tangible property paid in: mixture of tangible and intangible property.—*

"Where stock or shares and bonds or other obligations have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. Where stock or shares have been issued for a mixed aggregate of tangible and intangible property and certain liabilities have been assumed in connection with the transaction, it will be presumed that such liabilities are to be charged against the tangible property and the intangible property in the order named, unless it is shown by evidence satisfactory to the Commissioner that this presumption is not in accordance with the facts."

PROBLEM 315

Illustrating Realization of Appreciation as Affecting Invested Capital

FACTS:

The Fairborn Furniture Corporation purchased a large tract of land containing valuable timber January 1, 1903, at a cost of $500,000, $100,000 of which was paid for the land on which the timber stood. On March 1, 1913, the timber was valued at $1,000,000 upon an appraisal by experts. The corporation did

not enter the $1,000,000 value on its books, but claimed depletion on the basis of this value. From 1913 to 1920, inclusive, the company wrote off depletion amounting to $160,000. On the basis of cost the depletion for the same period would have been $64,000.

QUESTION:

Is the corporation entitled to any part of the depletion of $160,000 as invested capital for the calendar year 1921?

ANSWER:

The difference between the depletion based upon March 1, 1913 value ($160,000) and the depletion based upon cost ($64,000), or $96,000, represents realized appreciation and is therefore properly a part of surplus to be included in the 1921 invested capital, if it is still in use in the business.

REFERENCE:

Art. 844, Regulations 62: ". . . Reserves for depreciation or depletion can not be included in the computation of invested capital, except to the following extent: . . . (2) Where depreciation or depletion is computed on the value as of March 1, 1913, or as of any subsequent date, the proportion of depreciation or depletion representing the realization of appreciation of value at March 1, 1913, or such subsequent date, may if undistributed and used or employed in the business be treated as surplus and included in the computation of invested capital."

PROBLEM 316

Illustrating Effect on Invested Capital of Payment of Federal Income and Excess-Profits Tax for the Previous Year

FACTS:

The Tirrell Washer Corporation, which reports on the calendar-year basis, had outstanding capital stock of $200,000 and a surplus of $50,000 on December 31, 1920. The Federal income and excess-profits tax liability for 1920 was $40,000. Except for the adjustments necessary on account of the payment of the 1920 Federal income and profits taxes in 1921, the capital and

surplus as of January 1, represented the invested capital of the company for 1921.

QUESTION:

What is the invested capital for 1921?

ANSWER:

The invested capital is \$233,095.89 as under:—

Capital stock	\$200,000	
Surplus	50,000	
Total	\$250,000	

Less: Adjustment for 1920 Federal taxes paid:

One-fourth payable March 15th, 292 days × 10,000 =	\$2,920,000	
One-fourth payable June 15th, 200 days × 10,000 =	2,000,000	
One-fourth payable Sept. 15th, 108 days × 10,000 =	1,080,000	
One-fourth payable Dec. 15th, 17 days × 10,000 =	170,000	
	\$6,170,000	
\$6,170,000 ÷ 365		16,904.11
Invested capital		\$233,095.89

REFERENCE:

Art. 845, Regulations 62: "Surplus and undivided profits: reserve for income and excess-profits taxes.—For the purpose of computing invested capital, Federal income and war-profits and excess-profits taxes are deemed to have been paid out of the net income of the taxable year for which they are levied. It is immaterial, therefore, whether reserves for the payment of such taxes for the preceding year have been set up or not, or if set up whether such taxes when paid

have actually been charged against such reserves. Amounts payable on account of such taxes for the preceding year may be included in the computation of invested capital only until such taxes become due and payable. A deduction from the invested capital as of the beginning of the taxable year must therefore be made for such taxes or any installment thereof, averaged for the proportionate part of the taxable year after the date when the tax or the installment is due and payable. . . ."

NOTE:

As pointed out on page 133 of the author's book on Federal Corporate Income Taxes, the adjustment of the invested capital of any calendar year for Federal income and profits taxes paid for the previous calendar year may be simplified by taking 42.260274 per cent. (42.144809 in 1920, a leap year) of the amount of Federal income and profits taxes payable for the preceding year. In the above problem, 42.260274% of $40,000 is $16,904.11.

PROBLEM 317

Illustrating Inclusion in Invested Capital of Insurance on Life of an Officer of a Corporation

FACTS:

The Bolton Iron Corporation, in order to protect itself, insured the life of Mr. James Bolton, president, for $10,000, naming itself as beneficiary under the policy. The cash surrender value of the policy on the first day of the company's taxable year 1921 was $4,000, and the premiums paid up to that date amounted to $5,000.

QUESTION:

May the corporation include this policy in its invested capital for 1921, and if so, at what value?

ANSWER:

It may include the policy in its invested capital at $4,000, the cash surrender value.

REFERENCE:

Art. 846, Regulations 62: "Where insurance is carried by the corporation on the life of an officer or employee, the policy may be included as an admissible asset and reflected in the surplus account at the cash surrender value as of the beginning of the taxable year. The whole amount of premiums paid on such insurance can not be included in surplus, but the surplus will be considered as increased as of the beginning of each taxable year by the amount added to the cash surrender value of the policy."

PROBLEM 318

Illustrating Method of Arriving at Amount of Net Income Available for Distribution as Dividend.—Effect on Invested Capital

FACTS:

The Muldoon Machinery Corporation, which closes its accounts only on December 31, had a taxable net income in the calendar year 1921 of $270,000. Except for a dividend of $90,000 declared payable April 1, 1921, no transactions took place within the year to reduce the amount of current earnings applicable against the dividend, such as the retirement of the company's own capital stock previously issued, the purchase of inadmissibles, etc. The outstanding capital stock of the company January 1, 1921, was $900,000, and the surplus on that date, $225,000. Except for the adjustment necessary on account of the dividend of April 1, the total of the capital stock and surplus as of January 1, represented the invested capital of the company for 1921.

QUESTION:

What is the invested capital of the company for 1921?

ANSWER:

The invested capital is $1,095,287.92, as under:

Capital stock January 1, 1921	$900,000.00
Surplus	225,000.00

Invested capital January 1, 1921			$1,125,000.00
Total earnings for 1921			270,000.00
Dividends paid April 1, 1921			90,000.00
Proportionate part of earnings to April 1, 1921 (¼)			67,500.00
Excess-profits credit:			
8% of $1,125,000		$90,000	
Specific exemption		3,000	93,000.00
Proportion of credit to April 1, 1921 ($\frac{90}{365}$ of $93,000)			22,931.51
Invested capital applicable to the period, January 1 to April 1, ($\frac{90}{365}$ of $1,125,000)			277,397.26
Computation of tax:			
20% of invested capital		$55,479.45	
Less: Excess-profits credit		22,931.51	Tax
Amount subject to 20% tax		$32,547.94	$6,509.59
" " " 40% "		12,020.55	4,808.22
Total excess-profits tax			$11,317.81
Income to April 1, 1921		$67,500.00	
Less: Excess-profits tax		11,317.81	
Taxable at 10%		$56,182.19	5,618.22
Total income and profits tax accrued to April 1			$16,936.03
Dividend payable April 1		$90,000.00	
Income to April 1	$67,500.00		
Taxes accrued to April 1	16,936.03		
Net income available for dividends		50,563.97	
Amount of dividend paid out of surplus			39,436.03

Invested capital January 1	$1,125,000.00
Deduction from invested capital on account of dividend paid out of surplus ($39,436.03 $\times \frac{275}{365}$)	29,712.08
Invested capital for 1921	$1,095,287.92

REFERENCES:

Art. 857, Regulations 62: "Method of determining available net income.—Whether at the time of any payment made during the taxable year there is sufficient income of the taxable year available for such payment, or whether the surplus or undivided profits as of the beginning of the taxable year must be reduced by the amount of such payment, shall be determined according to the following principles:

(1) The aggregate amount of earnings of the taxable year available for all purposes up to any given date will be determined upon the basis of the same proportion of the net income for the taxable year, (as finally determined for the purpose of income and excess-profits taxes) as the part of the year already elapsed is of the entire year (determined in the manner provided in article 853), unless the corporation shows from its books or other records that a greater proportion of its earnings for the year was available on such date.

(2) The aggregate amount available will be deemed to be applied for the following purposes in the order in which they are stated: (*a*) Accrued federal income and war profits and excess-profits taxes for the taxable year (see article 845), and (*b*) dividends paid after the expiration of the first sixty days of the taxable year (see section 201 of the statute and article 1541) and other corporate purposes, including the purchase of outstanding stock of the corporation previously issued (see article 862). In any case where the above computation would be indeterminate because of the effect of the provisions of this article upon the invested capital for the year, the amount of such invested capital for the purpose of this computation may be deemed to be the invested capital as of the beginning of the taxable year, plus any additional capital paid in during such year and minus any specific withdrawal or liquidation of capital during such year."

See Bul. 31-20-1110; O. D. 619 for further illustration.

PROBLEM 319

Illustrating Effect on Invested Capital of Cash Dividend Paid in the First Sixty Days of the Distributing Company's Taxable Year which Dividend is Greater in Amount than the Surplus at End of Previous Year

FACTS:

The Up-To-Date Furnishers, Inc., which keeps its books on the calendar year basis, showed on its balance sheet as of January 1, 1921, an earned surplus of $10,000. The company declared a dividend payable February 1, 1921, of $25,000. Its income for the calendar year 1921 after providing for accrued Federal income and profits taxes was $30,000.

QUESTION:

How does this dividend affect invested capital for 1921?

ANSWER:

$10,000 of the dividend will come out of invested capital as of February 1, 1921, being paid in the first 60 days. Of the remaining $15,000, $12,500 will come out of invested capital as of February 1, 1921, this being the excess of the amount of the dividend over the earnings for January ($30,000 divided by 12). Since there is not enough surplus from the prior year, current year earnings have to be considered to February 1, 1921.

REFERENCES:

Art. 858, Regulations 62: ". . . The surplus and undivided profits as of the beginning of the taxable year will be reduced as of the date when the dividend is payable by the entire amount of any dividend paid during the first sixty days of the taxable year and by the amount of any other dividend in excess of the current net income available for its payment. In the case of a dividend paid during the first sixty days of a taxable year which exceeds in amount the surplus and undivided profits as of the beginning of the taxable year the excess will be deemed to be paid out of earnings of the taxable year available at the date when the dividend is payable, and to the extent that such

earnings are insufficient it will be deemed to be a liquidation of paid-in capital or surplus. . . ."
Sec. 201 (f) (Quoted under Problem 12)

PROBLEM 320

Illustrating Effect of Stock Dividend on Invested Capital

FACTS:

The Lewis Lace Selling Corporation, which keeps its books on the calendar-year basis, declares a stock dividend payable February 15, 1921 in the amount of $50,000.

QUESTION:

What is the effect of this dividend on invested capital for 1921?

ANSWER:

None, except that if cash dividends are paid later in the year, the stock dividend will serve to reduce the amount of current earnings available for application against such cash dividends.

REFERENCE:

Art. 859, Regulations 62: "Neither the payment nor the receipt of a true stock dividend has any effect upon the amount of invested capital. . . ."

PROBLEM 321

Illustrating Effect of Operating Deficit on Invested Capital

FACTS:

The U-No-Us Cigar Company at the beginning of its taxable year has an operating deficit of $25,000.

QUESTION:

In computing invested capital must this fact be taken into consideration, and the amount of the deficit be deducted from capital and surplus originally paid in, in order to compute the invested capital?

ANSWER:

No. An operating deficit does not ordinarily affect invested capital through a reduction of the original investment representing capital or surplus paid in. However, if surplus reserves (not paid in) are to be included in invested capital, they must be reduced by the amount of this deficit.

REFERENCE:

Art. 860, Regulations 62: "Capital or surplus actually paid in is not required to be reduced because of an operating deficit, but where there has been directly or indirectly a liquidation or return of their investment to the stockholders, full effect must be given to any liquidation of the original capital."

PROBLEM 322

Illustrating the Computation of the Invested Capital of a Corporation for a Fractional Part of a Year

FACTS:

The Inventories Computing Corporation was organized September 1, 1921, with an authorized capital stock of $100,000, of which $50,000 was issued for cash at par on September 1, 1921. On November 1 an additional $25,000 was issued for cash at par. There were no other transactions affecting the invested capital of the company. The company keeps its books on the calendar-year basis.

QUESTION:

What is the invested capital of the company for the period September 1 to December 31, 1921, inclusive?

ANSWER:

The invested capital is $20,890.41, and is computed as follows:

Fifty thousand dollars were invested in the business during the full period of 122 days and $25,000 were invested for only 61 days (Nov. 1 to Dec. 31, inclusive).

$50,000 plus ($\frac{61}{122}$ of $25,000) equals $62,500, the total in-

vested capital for the period. This must be reduced by the fraction which the taxable period is of a full year. The statutory invested capital is therefore, $\frac{122}{365}$ of \$62,500, or \$20,890.41.

REFERENCES:

Sec. 326 (d): "The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital."

For further illustration see Art. 856, Reg. 62.

PROBLEM 323

Illustrating Computation of Excess-Profits Tax for a Fractional Part of a Year

FACTS:

The Powell Paper Company, a domestic concern incorporated July 1, 1921, closed its books December 31, 1921, and showed a taxable net income of \$40,000 for the six-months period ended on that date. The invested capital of the company for the six months was \$250,000. The company files its first return for the six months ended December 31, 1921.

QUESTION:

What is the amount of the excess-profits tax for the six months period?

ANSWER:

The tax is \$8,700, computed as under:

Invested capital	\$250,000
Net income for 6 months	40,000
Net income, at same rate, for full year ($^{12}/_{6}$ of \$40,000)	80,000
Excess-profits credit:	
1. Eight per cent of invested capital	\$20,000
2. Specific exemption	3,000
Excess-profits credit	\$23,000

Computation of Excess-profits Tax

Bracket	Amount of net income in each bracket	Excess-profits credit	der subject to tax	Rate	Amount of tax
1. Not over 20% of invested capital . .	$50,000	$23,000	$27,000	20%	$5,400
2. Over 20% of in-invested capital . .	30,000	—0—	30,000	40%	12,000
Total	$80,000	$23,000	$57,000		17,400

The excess-profits tax for the six-months period will be 6/12 of the $17,400 shown above, or $8,700.

REFERENCES:

Sec. 326 (d) (Quoted under Problem 322)

Sec. 305: "That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000, as the number of months in the period is of twelve months."

NOTE:

In the solution to this problem the method outlined in Article 718, Regulations 62, has been followed, which the author regards as a common-sense solution, despite the fact that a literal reading of the statute would not appear to warrant the solution given. Thus, section 320 provides that for the purpose of the excess-profits tax the net income of a corporation shall be ascertained and returned for the taxable year upon the same basis and in the same manner as provided for income tax purpose in Title II. In Title II under section 239, paragraph (b), provision is made that corporations required to file income tax returns are subject to the provisions of section 226. Paragraph (c) of section 226 provides that "in the case of a return for a period of less than one year the net income shall be placed on an annual basis by multiplying the amount thereof by twelve and dividing by the number of months included in such period; and

the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.'' Accordingly, the net income of the Powell Paper Company would be put on an annual basis, which would give $80,000. The invested capital in accordance with paragraph (d) of section 326 is required to be reduced. With the income and invested capital adjusted in the manner just described it is clear that the resulting excess-profits tax would be out of proportion to what Congress evidently intended.

PROBLEM 324

Illustrating Case in Which Profits Tax is Assessed by Comparison with Representative Concerns—Commissioner Unable to Determine Invested Capital According to Ordinary Method

FACTS:

The New Bedford Company is a New England cotton mill, organized in 1885, resulting from the incorporation of a partnership. The assets as taken over by the corporation were valued very conservatively, some being set up at merely nominal amounts. It has been the consistent policy of the corporation to charge off as expenses additions and betterments which should have been capitalized. It is impossible at this date to make proper adjustments in order to state invested capital in accordance with Sec. 326.

QUESTION:

Would these irregularities warrant assessing the excess-profits tax for 1921 under Sec. 328, providing for comparison with representative corporations?

ANSWER:

Yes.

REFERENCE:

Sec. 327: "That in the following cases the tax shall be determined

as provided in Sec. 328: (a) Where the Commissioner is unable to determine the invested capital as provided in Sec. 326. . . ."

NOTE:

Section 328 provides for the assessment of the excess-profits tax by comparison with representative concerns. See Problem 330.

PROBLEM 325

Illustrating Case in Which Profits Tax is Assessed by Comparison with Representative Concerns—Foreign Corporations

FACT:

Wing Lee & Co., a foreign corporation located in Canton, China, deals in chinaware which it manufactures abroad and sells principally in this country through its own branches here. Its records are clear and its investment in this country could be stated accurately together with the profits earned here.

QUESTION:

How will the company's 1921 excess-profits tax, if any, be determined?

ANSWER:

The company's 1921 excess-profits tax, if any, will be determined by comparison with representative concerns in accordance with section 328.

Being a foreign corporation it comes specifically within the purview of section 327 (b) requiring such assessment.

REFERENCE:

Sec. 327: "That in the following cases the tax shall be determined as provided in section 328: . . . (b) In the case of a foreign corporation. . . ."

PROBLEM 326

Illustrating Case in Which Profits Tax Is Assessed by Comparison with Representative Concerns—Corporations Entitled to Benefits of Section 262

FACTS:

The Martini Company, a domestic corporation, has a branch in the Philippine Islands. The Martini Company's accounting year closes December 31. For the years 1919, 1920, and 1921, the Philippine branch produced in the regular conduct of its business gross income amounting to at least 80 per cent of the total gross income of the Martini Company. None of the income of the Philippine branch was brought into the United States during the taxable year. The Martini Company is able from its records to clearly compute its statutory invested capital.

QUESTION:

Upon what basis will its 1921 excess-profits tax, if any, be assessed?

ANSWER:

From the facts above stated the Martini Company comes within the scope of section 262. Its profits tax will therefore be determined as provided in section 328 notwithstanding its ability to clearly state its invested capital, because of the specific provision in section 327 directing that a corporation coming within the purview of section 262 be taxed under section 328.

REFERENCE:

Sec. 327: "That in the following cases the tax shall be determined as provided in section 328: . . . (b) In the case of a . . . corporation entitled to the benefits of section 262. . . ."

PROBLEM 327

Illustrating Case in Which Profits Tax is Assessed by Comparison with Representative Concerns—Mixed Aggregate of Tangibles and Intangibles Paid in for Stock and Bonds

FACTS:

In 1910 the Brooks Corporation issued $50,000 par value of stock and $25,000 par value of bonds to W. B. Brooks in payment for tangible and intangible assets of a total value of at least the par value of the securities issued therefor. There is not sufficient information to determine whether the intangibles were paid for with stock or with bonds, or to determine the respective values of the tangibles and intangibles at the time they were paid in.

QUESTION:

Would such a circumstance warrant assessment of the Brooks Corporation under section 328?

ANSWER:

Yes.

REFERENCE:

Sec. 327: "That in the following cases the tax shall be determined as provided in section 328: . . . (c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stocks and for bonds, respectively; . . ."

PROBLEM 328

Illustrating Case in Which Profits Tax is Assessed by Comparison with Representative Concerns—Abnormal Conditions Affecting Invested Capital—Income in Current Year from Advertising in Prior Years

FACTS:

The Novelty Corporation, manufacturing a trade-marked

article, was obliged during the first four or five years after its organization in 1912 to advertise extensively, thus extending its sales until a substantial demand was created and the article became sufficiently known to carry itself. The procedure was to advertise in one section until the demand was created and as soon as that section began to show a profit to invest such profit in advertising in another section, and so on. The cost of this advertising was not capitalized but was written off the books as the expenditures were made. The statutory invested capital of the company is 150% of its 1921 income. The income of the taxable year was to a material extent the result of earlier advertising campaigns.

QUESTION:

Would The Novelty Corporation be entitled to the assessment of its 1921 excess profits tax under Sec. 328?

ANSWER:

The Bureau of Internal Revenue has ruled in a similar case that where large sums had been spent in advertising, thereby creating good will and an earning capacity far in excess of recognizable invested capital, abnormal conditions affecting invested capital were created, as a result of which the case came within the group referred to in paragraph (d) of Sec. 327 and the assessment of the profits tax was required to be made on the basis of the tax paid by representative corporations. Accordingly, in all probability, the Bureau will assess the profits tax of this corporation for 1921, under the terms of Sec. 328.

REFERENCES:

Sec. 327: "That in the following cases the tax shall be determined as provided in section 328: . . . (d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without

benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, . . ."

Bul. 2-20-679; A. R. M. 12: ". . . Upon the question of an addition to invested capital through the recognition of a portion of the amounts spent in prior years for advertising and developing trademarks and trade brands. . . . the Committee. . . . recommends that the percentage of tax to income in the cases of those corporations which have an adequate recognizable invested capital be determined, and that other cases which have no such invested capital be regarded as coming within the scope of section 327 and the tax properly to be computed under section 328."

PROBLEM 329

Illustrating Case in Which Assessment by Comparison with Representative Concerns is Denied—Gains from Government Contracts

FACTS:

The Baldwin Contracting Company on October 1, 1918, was awarded a contract by the United States Government for 15,000 blankets on a cost-plus basis, the Government reserving the right to make certain minor changes in the specifications. The amount to be added to or deducted from the contract by reason of such changes was to be agreed upon in writing. Soon after the signing of the armistice a second contract, embodying the modifications above referred to, was entered into. In accordance with the modified contract, the Baldwin Contracting Company was directed early in 1921, to furnish half the quantity of blankets originally specified, at an agreed price. The income derived from the contract which was completed in the taxable year 1921, exceeded 50% of the company's gross income. The company was in poor financial condition and, as a matter of fact, its capital was merely nominal. It was able to complete its Government contract only by turning the same over to a subcontractor. However, its net income for 1921 was rather substantial; in fact, it was in excess of ten times the amount of its statutory invested capital. Under the circumstances, it

plans to file with the Treasury Department a petition for the assessment of its excess-profits tax by comparison with representative concerns in accordance with the provisions of section 328.

QUESTION:

Would this petition be granted?

ANSWER:

Owing to the provision in section 327 (d) with respect to corporations earning more than 50 per cent of their gross income from Government contracts on the cost-plus basis, the Baldwin Contracting Company would apparently be denied assessment under section 328.

REFERENCES:

Sec. 327 (d): ". . . This subdivision shall not apply in any case . . . (2) in which 50 per centum or more of the gross income of the corporation for the taxable year . . . consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive."

Bul. I ('22)-2-16, Sol. Op. 128: "Supplemental contracts made with a department of the United States Government after November 11, 1918, modifying original contracts entered into between April 6, 1917, and November 11, 1918, between the same parties, are 'Government contracts' entered into between April 6, 1917, and November 11, 1918, within the meaning of the Revenue Act of 1918 and the income therefrom is taxable under Section 301 (c) of the above Act."

PROBLEM 330

Illustrating Factors Governing Selection of Representative Corporations to Determine Percentage to Apply to Income in the Case of Corporations Assessable Under Section 328

FACTS:

The Acme Machine Tool Company, a domestic corporation, is engaged in the business of manufacturing a certain class of machine tools. It has been decided by the Income Tax Unit, for appropriate reasons, that the corporation is entitled to the

assessment of its excess-profits tax for 1921, under section 328, that is, by comparison with representative concerns.

QUESTION:

What factors would govern the selection of returns of corporations which may be said to be representative, in order to determine the percentage to be applied to the company's net income for the purpose of arriving at its excess-profits tax for 1921?

ANSWER:

Based upon the procedure of the Income Tax Unit in the past, the following may be said: While the corporations listed on the Acme Machine Tool Company's return as being in the same line of business will be considered, the returns of other corporations will be obtained and considered until, if possible, at least six have been selected as representative. Only corporations whose invested capital has been determined under section 326 will be used. The Government auditors try to obtain audited returns of corporations in the same line of business having as nearly as possible the same gross and net income, and, if possible, situated in the same locality. However, in the absence of concerns in the same line of business those in similar or comparable lines will be used; if it is not possible to obtain corporations with approximately the same gross sales and net income, several above or below may be taken to give a fair average. The Bureau thus arrives at the ratio which the average tax of these representative corporations bears to their average net income (in excess of the specific exemption of $3,000.00) for 1921. This ratio is applied to the net income (in excess of $3,000.00) to determine the excess-profits tax payable.

REFERENCES:

Sec. 328: "(a) That in the cases specified in section 327 the tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In

the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

"In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war-profits or excess-profits, and all other relevant facts and circumstances.

"(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary.

"(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257."

Art. 911, Regulations 62: "Computation of tax in special cases: —In the cases specified in section 327 of the statute the tax is to be computed by comparison with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are engaged in a like or similar trade or business and similarly circumstanced. The provisions of section 328 do not permit the determination of a general average for any trade or business. In each case which comes under the provisions of section 327 the Commissioner will determine, as nearly as may be, the group or class of corporations with which the corporation should be compared and the amount which bears the same ratio to the net income of the corporation (in excess of the specific exemption of $3,000) for the taxable year as the average tax of such representative corporations bears to their average net income (in excess of the specific exemption of $3,000) for such year. The comparison will take account of similarity with respect to character of business, size and condition of plant, gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances."

NOTE:

In the case of a foreign corporation or a corporation entitled to the benefits of section 262 the profits tax is computed in the same manner as stated in the answer to the foregoing

problem excepting that the specific exemption of $3,000.00 is not deducted either for the taxpayer or the representative corporations.

PROBLEM 331

Illustrating Computation of Invested Capital in Case of Reorganization, Consolidation, or Change of Ownership of Property, After March 3, 1917, in Which an Interest or Control of Less Than Fifty Per Cent Remains in the Same Persons, or Any of Them

FACTS:

The Pompon Hat Company which was owned by an individual, Max Pompon, on February 1, 1918, sold out its business to the Pompon Hat Corporation. The assets of the Pompon Hat Company, including nothing for goodwill, which had a cash value of $50,000, were valued at $50,000. The Pompon Hat Corporation bought these assets for $100,000, paying therefor $25,000 in cash and $75,000 in its own capital stock. The shares of stock received by Mr. Pompon represented only 25% of the entire capital stock issued, the other 75% being owned by other individuals. The capital stock of the Pompon Hat Corporation as of January 1, 1921, was $300,000, and the surplus $20,000. Except for any adjustment to be made on account of the acquisition of the Pompon Hat Company's business, the capital and surplus of the corporation January 1, 1921, represented its invested capital for 1921. The goodwill is carried on the books of the corporation at $50,000.

QUESTION:

What is the invested capital for 1921?

ANSWER:

The invested capital is $320,000, as under:

Capital stock and surplus $320,000

Since upon the sale of the business of the Pompon Hat Company, the interest of Max Pompon which remained in the prop-

erty of the Pompon Hat Company through his ownership of the stock of the Pompon Hat Corporation was less than 50%, the limitations prescribed in section 331 in the case of reorganizations, etc., do not apply.

In the absence of evidence to the contrary, it is to be assumed that the $25,000 cash was paid for tangible property. Therefore, the good will was acquired entirely with stock, i. e., good will valued at $50,000 was acquired for $50,000 par value of stock. It is necessary to apply the limitations with respect to intangible property acquired with capital stock after March 3, 1917, in order to determine what adjustments if any, should be made in connection with the computation of invested capital.

Par value of stock issued for good will	$50,000
Cash " " good will when acquired	50,000
25% of capital stock outstanding on January 1, 1921, ($300,000)	75,000

Since the value at which the good will is carried on the books of the corporation is not in excess of any of the limitations, no adjustment of invested capital is necessary.

REFERENCES:

Sec. 331: (Quoted under Problem 332.)

Art. 835, Regulations 62: "Where stock or shares and bonds or other obligations have been issued for a mixed aggregate of tangible and intangible property, it will be presumed in the absence of satisfactory evidence to the contrary that the bonds were issued for tangible property and that the stock was issued for the balance of the tangible property, if any, and for the intangible property. . . ."

PROBLEM 332

Illustrating the Computation of Invested Capital in the Case of a Corporation Reorganized after March 3, 1917, an Interest of More Than Fifty Per Cent Remaining in the Same Persons

FACTS:

The Cellulose Manufacturing Corporation took over the assets of the Frier Brothers Corporation June 30, 1917, and issued its whole capital stock of $500,000 therefore to the old

stockholders of the Frier Brothers Corporation, which amount represented the net value on that date of the assets (all tangible) acquired. The original cost of the assets was $400,000.

QUESTION:

Can the increased value be included in invested capital under the 1921 Act?

ANSWER:

No. The assets acquired by the new company from the old cannot be taken into the invested capital of the new company at a figure greater than that at which they would have been permitted to be taken into the invested capital of the old company had there been no reorganization.

REFERENCE:

Sec. 331: "That in the case of the reorganization, consolidation, or change of ownership of a trade or business, or change of ownership of property, after March 3, 1917, if an interest or control in such trade or business or property of 50 per centum or more remains in the same persons, or any of them, then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred or received: Provided, That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation."

PROBLEM 333

Illustrating the Computation of 1921 Invested Capital In the Case of a Corporation Organized After March 3, 1917, to Take Over the Net Assets of Two or More Businesses

FACTS:

The Acme Axle Company was organized January 1, 1921, with

an authorized capital stock of $750,000 (all of one class) to take over the business of the Banner Brake Company, the Speedster Spoke Company, and the Walkover Wheel Company, the stockholders of each of these companies just prior to the sale of their respective businesses being separate individuals. The stockholders of the three companies last named turned over all the assets of these companies to the Acme Axle Company for stock in the new corporation equal to the cash value of the net tangibles turned over, as follows:

Company	Cash value of net tangible assets, Jan. 1, 1921	Par value of Acme Axle Co. stock received	Proportion of entire stock of Acme Axle Co.
Banner Brake Co.	$400,000	$400,000	53⅓%
Speedster Spoke Co.	250,000	250,000	33⅓%
Walkover Wheel Co.	100,000	100,000	13⅓%
	$750,000	$750,000	100%

If no reorganization had taken place, the assets of the three old companies could have been taken into the respective invested capitals for 1921, at the following values:

Banner Brake Co.	$250,000
Speedster Spoke Co.	187,500
Walkover Wheel Co.	62,500
Total	$500,000

The new company files its first return for the calendar year 1921. The status of the company at January 1, 1921, reflects its invested capital for the entire year.

QUESTION:

What is the invested capital of the Acme Axle Company for 1921?

ANSWER:

$600,000, as under:

The stockholders of the Banner Brake Company continue to have an interest in excess of 50% in the assets transferred by them to the Acme Axle Company. Therefore, these assets cannot be included in the Axle Company's invested capital at a figure higher than they could have been included in the Brake Company's invested capital, i. e., $250,000. The assets transferred by the stockholders of the other two companies, since the stockholders of these companies now have less than 50% interest in the assets transferred, will be taken into invested capital at their value on the date paid in, January 1, 1921.

The invested capital of the Acme Axle Company, is, therefore, as follows:

Assets paid in by Banner Brake Co.	$250,000
" " " " Speedster Spoke Co.......	250,000
" " " " Walkover Wheel Co.......	100,000
Invested capital of new corporation	$600,000

REFERENCE:

Sec. 331: (Quoted under Problem 332.)

PROBLEM 334

Illustrating the Computation of the Excess-Profits Tax in the Case of a Domestic Corporation (Other Than a Personal Service Corporation) Having a Fiscal Year Ending in 1921

FACTS:

The Danbury Crown Company, a domestic corporation, reports on the basis of a fiscal year ending June 30th.

For the year ended June 30, 1921, the company reports an income under the 1918 Act of $250,000, and under the 1921 Act an income of $240,000, the income differing by reason of the fact that an allowable addition to the reserve for bad debts has

been taken as a deduction under the 1921 Act. The invested capital of the corporation for that fiscal year is $900,000.

QUESTION:

What is the excess-profits tax for the fiscal year ended June 30, 1921?

ANSWER:

Computation of tax under 1918 Act:

Invested capital		$900,000
Excess-profits credit:		
8% of invested capital	$72,000	
Specific exemption	3,000	75,000
Net income (1918 Act)		$250,000
20% of invested capital	$180,000	
Less: Exemption	75,000	
		Tax
Subject to tax at 20%	$105,000	21,000
Balance subject to tax at 40%	70,000	28,000
Excess-profits tax (1918 Act)		$49,000

Tax for 6 months ending December 31, 1920 = 6/12 of the excess-profits tax computed for the entire period under the 1918 Act, or 6/12 of $49,000, which is $24,500.

Computation of tax under 1921 Act:

Invested capital		$900,000
Excess-profits credit (same as under 1918 Act)		75,000
Net income (1921 Act)		240,000
20% of invested capital	$180,000	
Less: Exemption	75,000	
		Tax
Subject to tax at 20%	$105,000	$21,000
" " " " 40%	60,000	24,000
Excess-profits tax (1921 Act)		$45,000

Excess-profits tax for 6 months ending June 30, 1921=$\frac{6}{12}$ of the excess-profits tax computed for the entire twelve-months period, or $\frac{6}{12}$ of \$45,000, which is \$22,500.

Total excess-profits tax for the fiscal year ended June 30, 1921, equals the sum of the taxes as computed for the six months under the 1918 Act and the six months under the 1921 Act.

Excess-profits tax computed under 1918 Act..	\$24,500
" " " " " 1921 Act..	22,500
Total excess-profits tax for the fiscal year	\$47,000

Reference:

Sec. 335 (a): "That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning in 1920 and ending in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. . . ."

PROBLEM 335

Illustrating the Computation of Excess-Profits Taxes for a Corporation Having a Fiscal Year Ending in 1922

Facts:

The Klein Silk Company is a domestic corporation and is located in New York City. It reports on the fiscal-year basis ending March 31 of each year. For the year ended March 31, 1922, it reports a net income of \$300,000 under the Act of 1921. At the beginning of the taxable year the invested capital was \$1,200,000. There were no changes in invested capital during the year.

Question:

What is the excess-profits tax liability of the corporation?

ANSWER:

$39,150, computed as follows:

Net income subject to tax	$ 300,000
Invested capital	1,200,000
Exemption 8%	96,000
Specific exemption	3,000
Total exemption	$ 99,000

	Income	Exemption	Balance	Rate	Tax
20% of invested capital	$240,000	$99,000	$141,000	20%	$28,200
Balance	60,000	—0—	60,000	40%	24,000
	$300,000	$99,000	$201,000		$52,200

Excess-profits tax for 9 months in 1921=9/12 of $52,200= $39,150.

REFERENCES:

Sec. 335 (b): "If a corporation (other than a personal service corporation) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period."

For further illustration see Art. 955, Regulations 62.

See Problem 44 for computation of full tax liability of corporation for fiscal year ended in 1922.

PROBLEM 336

Illustrating Limitation on Excess-Profits Tax in Case of Sale of Mine

FACTS:

The Sioux Holland Company, a New Jersey corporation, agents for farm property, in 1921 sells for $1,000,000 a mine which the company in 1916, had discovered on some of its property which it had acquired for no consideration many years before. The mine was located on land which on March 1, 1913,

had been considered worthless. The expense of making the sale was $10,000. In addition to the $990,000 profit on the mine, the company had ordinary net income of $210,000. The company reports on the calendar year basis. Its invested capital for 1921, is $2,000,000.

PROBLEM:

Compute the excess-profits tax for 1921.

SOLUTION:

Excess profits-credit, $3,000 plus 8 per cent of $2,000,000, or $163,000.

Bracket	Income	Credit	Balance	Rate	Tax
1	$400,000	$163,000	$237,000	20%	$ 47,400
2	800,000	—0—	800,000	40%	320,000
	$1,200,000	$163,000	$1,037,000		$367,400

Since the profit from the sale of the mine was $990,000 and the total taxable net income was $1,200,000, the portion of the net income attributable to the sale is $\frac{990,000}{1,200,000}$, or 82½%. This percentage of the $367,400 surtax arrived at by the above computation is $303,105, but this portion of the tax under the provisions of Sec. 337, can not exceed 20% of the selling price ($1,000,000) and must accordingly be reduced to $200,000. The other 17½% of the $367,400, or $64,295, need not be reduced. The total surtax is therefore $200,000 plus $64,295, or $264,295.

REFERENCES:

Sec. 337: "That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale shall not exceed 20 per centum of the selling price of such property or interest."

See Art. 972, Reg. 62 for further illustration.

APPENDIX

REVENUE ACT OF 1921[1]

[H. R. 8245.]

An Act To reduce and equalize taxation, to provide revenue, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

TITLE I.—GENERAL DEFINITIONS

SECTION 1. That this Act may be cited as the "Revenue Act of 1921."

SEC. 2. That when used in this Act—

(1) The term "person" includes partnerships and corporations, as well as individuals;

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies;

(3) The term "domestic" when applied to a corporation or partnership means created or organized in the United States;

(4) The term "foreign" when applied to a corporation or partnership means created or organized outside the United States;

(5) The term "United States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia;

(6) The term "Secretary" means the Secretary of the Treasury;

(7) The term "Commissioner" means the Commissioner of Internal Revenue;

[1] Only those portions of the Act are reprinted here, which pertain to the income and profits taxes. The figures shown in the margins refer to the problems illustrating the sections opposite which the figures appear.

(8) The term "collector" means collector of internal revenue;

(9) The term "taxpayer" includes any person, trust or estate subject to a tax imposed by this Act;

(10) The term "military or naval forces of the United States" includes the Marine Corps, the Coast Guard, the Army Nurse Corps, Female, and the Navy Nurse Corps, Female, but this shall not be deemed to exclude other units otherwise included within such terms; and

(11) The term "Government Contract" means (a) a contract made with the United States, or with any department, bureau, officer, commission, board, or agency, under the United States and acting in its behalf, or with any agency controlled by any of the above if the contract is for the benefit of the United States, or (b) a subcontract made with a contractor performing such a contract if the products or services to be furnished under the subcontract are for the benefit of the United States. The term "Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive" when applied to a contract of the kind referred to in clause (a) of this subdivision, includes all such contracts which, although entered into during such period, were originally not enforceable, but which have been or may become enforceable by reason of subsequent validation in pursuance of law.

TITLE II.—INCOME TAX

PART I.—GENERAL PROVISIONS

DEFINITIONS

SEC. 200. That when used in this title—

(1) The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the net income is computed under section 212 or section 232. The term "fiscal year" means an accounting

Illustrated In Problem:

period of twelve months ending on the last day of any month other than December. The first taxable year, to be called the taxable year 1921, shall be the calendar year 1921, or any fiscal year ending during the calendar year 1921;

(2) The term "fiduciary" means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person, trust or estate;

(3) The term "withholding agent" means any person required to deduct and withhold any tax under the provisions of section 221 or section 237;

(4) The term "paid," for the purposes of the deductions and credits under this title, means "paid or accrued" or "paid or incurred," and the terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the net income is computed under section 212; and

(5) The term "personal service corporation" means a cor- 1
poration whose income is to be ascribed primarily to the ac- 2
tivities of the principal owners or stockholders who are themselves regularly engaged in the active conduct of the affairs of the corporation and in which capital (whether invested or borrowed) is not a material income-producing factor; but does not include any foreign corporation, nor any corporation 50 per centum or more of whose gross income consists either (1) of gains, profits, or income derived from trading as a principal, or (2) of gains, profits, commissions, or other income, derived from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

DIVIDENDS

SEC. 201. (a) That the term "dividend" when used in this
title (except in paragraph (10) of subdivision (a) of section 3
234 and paragraph (4) of subdivision (a) of section 245) means 4
any distribution made by a corporation to its shareholders
or members, whether in cash or in other property, out of its 5
earnings or profits accumulated since February 28, 1913, ex-
cept a distribution made by a personal service corporation 6

Illustrated In Problem: out of earnings or profits accumulated since December 31, 1917,
7 and prior to January 1, 1922.

(b) For the purposes of this Act every distribution is made
8 out of earnings or profits, and from the most recently accumulated earnings or profits, to the extent of such earnings or profits, accumulated since February 28, 1913; but any earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, may be distributed exempt from the tax, after the earnings and profits accumulated since February 28, 1913, have been distributed. If any such tax-free distribution has been made the distributee shall not be allowed as a deduction from gross income any loss sustained from the sale or other disposition of his stock or shares unless, and then only to the extent that, the basis provided in section 202 exceeds the sum of (1) the amount realized from the sale or other disposition of such stock or shares, and (2) the aggregate amount of such distributions received by him thereon.

9 (c) Any distribution (whether in cash or other property) made by a corporation to its shareholders or members other-
10 wise than out of (1) earnings or profits accumulated since February 28, 1913, or (2) earnings or profits accumulated or increase in value of property accrued prior to March 1, 1913, shall be applied against and reduce the basis provided in section 202 for the purpose of ascertaining the gain derived or the loss sustained from the sale or other disposition of the stock or shares by the distributee.

11 (d) A stock dividend shall not be subject to tax but if after the distribution of any such dividend the corporation proceeds to cancel or redeem its stock at such time and in such manner as to make the distribution and cancellation or redemption essentially equivalent to the distribution of a taxable dividend, the amount received in redemption or cancellation of the stock shall be treated as a taxable dividend to the extent of the earnings or profits accumulated by such corporation after February 28, 1913.

(e) For the purposes of this Act, a taxable distribution made
12 by a corporation to its shareholders or members, shall be in-
13 cluded in the gross income of the distributees as of the date

when the cash or other property is unqualifiedly made subject *Illustrated In Problem:*
to their demands.

(f) Any distribution made during the first sixty days of any taxable year shall be deemed to have been made from earnings or profits accumulated during preceding taxable years; but any distribution made during the remainder of the taxable years shall be deemed to have been made from earnings or profits accumulated between the close of the preceding taxable year and the date of distribution, to the extent of such earnings or profits, and if the books of the corporation do not show the amount of such earnings or profits, the earnings or profits for the accounting period within which the distribution was made shall be deemed to have been accumulated ratably during such period. This subdivision shall not be in effect after December 31, 1921.

BASIS FOR DETERMINING GAIN OR LOSS

SEC. 202. (a) That the basis for ascertaining the gain de- 14
rived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—

(1) In the case of such property, which should be included 15
in the inventory, the basis shall be the last inventory value thereof;

(2) In the case of such property, acquired by gift after De- 16
cember 31, 1920, the basis shall be the same as that which it
would have in the hands of the donor or the last preceding 17
owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor

Illustrated in Problem:

or last preceding owner. In the case of such property acquired by gift on or before December 31, 1920, the basis for ascertaining gain or loss from a sale or other disposition thereof shall be the fair market price or value of such property at the time of such acquisition;

18 (3) In the case of such property, acquired by bequest, devise, or inheritance, the basis shall be the fair market price or value of such property at the time of such acquisition. The provisions of this paragraph shall apply to the acquisition of such property interests as are specified in subdivision (c) or (e) of section 402.

19 (b) The basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March 1, 1913, shall be the same as that provided by subdivision (a); but—

24 (1) If its fair market price or value as of March 1, 1913, is in excess of such basis, the gain to be included in the gross income shall be the excess of the amount realized therefor over such fair market price or value;

20 (2) If its fair market price or value as of March 1, 1913, is lower than such basis, the deductible loss is the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and

21 (3) If the amount realized therefor is more than such basis
22 but not more than its fair market price or value as of March
23 1, 1913, or less than such basis but not less than such fair market price or value, no gain shall be included in and no loss deducted from the gross income.

(c) For the purpose of this title, on an exchange of property, real, personal or mixed, for any other such property, no gain or loss shall be recognized unless the property received
25 in exchange has a readily realizable market value; but even if the property received in exchange has a readily realizable market value, no gain or loss shall be recognized—

(1) When any such property held for investment, or for
26 productive use in trade or business (not including stock-in-

trade or other property held primarily for sale), is exchanged for property of a like kind or use; *Illustrated in Problem:*

(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected); or **27**

(3) When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation, or (B) two or more persons transfer any such property to a corporation, and immediately after the transfer are in control of such corporation, and the amounts of stock, securities, or both, received by such persons are in substantially the same proportion as their interests in the property before such transfer. For the purposes of this paragraph, a person is, or two or more persons are, "in control" of a corporation when owning at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation. **28**

(d) (1) Where property is exchanged for other property and no gain or loss is recognized under the provisions of subdivision (c), the property received shall, for the purposes of this section, be treated as taking the place of the property exchanged therefor, except as provided in subdivision (e); **29**

(2) Where property is compulsorily or involuntarily converted into cash or its equivalent in the manner described in **30** paragraph (12) of subdivision (a) of section 214 and paragraph (14) of subdivision (a) of section 234, and the taxpayer proceeds in good faith to expend or set aside the proceeds of such conversion in the form and in the manner therein pro-

Illustrated in Problem: vided, the property acquired shall, for the purpose of this section, be treated as taking the place of a like proportion of the property converted.

(3) Where no deduction is allowed for a loss or a part there-
31 of under the provisions of paragraph (5) of subdivision (a) of section 214 and paragraph (4) of subdivision (a) of section 234, that part of the property acquired with relation to which such loss is disallowed shall for the purposes of this section be treated as taking the place of the property sold or disposed of.

(e) Where property is exchanged for other property which
32 has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess; but when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the money or the fair market value of such other property received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess.

(f) Nothing in this section shall be construed to prevent (in
33 the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

INVENTORIES

34 Sec. 203. That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine
35 the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the appro-

val of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income. *Illustrated in Problem:*

NET LOSSES

SEC. 204. (a) That as used in this section the term "net loss" means only net losses resulting from the operation of any trade or business regularly carried on by the taxpayer (including losses sustained from the sale or other disposition of real estate, machinery, and other capital assets, used in the conduct of such trade or business); and when so resulting means the excess of the deductions allowed by section 214 or 234, as the case may be, over the sum of the following: (1) the gross income of the taxpayer for the taxable year, (2) the amount by which the interest received free from taxation under this title exceeds so much of the interest paid or accrued within the taxable year on indebtedness as is not permitted to be deducted by paragraph (2) of subdivision (a) of section 214 or by paragraph (2) of subdivision (a) of section 234, (3) the amount by which the deductible losses not sustained in such trade or business exceeds the taxable gains or profits not derived from such trade or business, (4) amounts received as dividends and allowed as a deduction under paragraph (6) of subdivision (a) of section 234, and (5) so much of the depletion deduction allowed with respect to any mine, oil or gas well as is based upon discovery value in lieu of cost. 36

(b) If for any taxable year beginning after December 31, 1920, it appears upon the production of evidence satisfactory 37 to the Commissioner that any taxpayer has sustained a net loss, the amount thereof shall be deducted from the net income of the taxpayer for the succeeding taxable year; and if such net loss is in excess of the net income for such succeeding taxable year, the amount of such excess shall be allowed as a deduction in computing the net income for the next succeeding taxable year; the deduction in all cases to be made under regulations prescribed by the Commissioner with the approval of the Secretary.

Illustrated in Problem: (c) The benefit of this section shall be allowed to the mem-
38 bers of a partnership and the beneficiaries of an estate or trust, and to insurance companies subject to the tax imposed
39 by section 243 or 246, under regulations prescribed by the Commissioner with the approval of the Secretary.

(d) If it appears, upon the production of evidence satis-
40 factory to the Commissioner, that a taxpayer having a fiscal year beginning in 1920 and ending in 1921 has sustained a net loss during such fiscal year, such taxpayer shall be entitled to the benefits of this section in respect to the same proportion of such net loss which the portion of such fiscal year falling within the calendar year 1921 is of the entire fiscal year.

FISCAL YEARS 1920-1921 AND 1921-1922

41 SEC. 205. (a) That if a taxpayer makes return for a fiscal year beginning in 1920 and ending in 1921, his tax under this title for the taxable year 1921 shall be the sum of: (1) the
44 same proportion of a tax for the entire period computed under Title II of the Revenue Act of 1918 at the rates for the calendar year 1920 which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title at the rates for the calendar year 1921, which the portion of such period falling within the calendar year 1921 is of the entire period.

Any amount paid before or after the passage of this Act
42 on account of the tax imposed for such fiscal year by Title II of the Revenue Act of 1918 shall be credited toward the payment of the tax imposed for such fiscal year by this Act, and if the amount so paid exceeds the amount of such tax imposed by this Act, the excess shall be credited or refunded in accordance with the provisions of section 252.

43 (b) If a taxpayer makes return for a fiscal year beginning in 1921 and ending in 1922, his tax under this title for the taxable year 1922 shall be the sum of: (1) the same proportion of a tax for the entire period computed under this
45 title (as in force on December 31, 1921) at the rates for the

Illustrated in Problem:

calendar year 1921 which the portion of such period falling within the calendar year 1921 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title (as in force on January 1, 1922) at the rates for the calendar year 1922 which the portion of such period falling within the calendar year 1922 is of the entire period: 46
Provided, That in the case of a personal service corporation the amount to be paid shall be only that specified in clause (2).

(c) If a fiscal year of a partnership begins in 1920 and ends in 1921, or begins in 1921 and ends in 1922, then (1) the rates 171
for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year.

CAPITAL GAIN

SEC. 206. (a) That for the purpose of this title:

(1) The term "capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921; 47

(2) The term "capital loss" means deductible loss resulting from the sale or exchange of capital assets consummated after December 31, 1921; 48

(3) The term "capital deductions" means such deductions as are allowed under this title for the purpose of computing net income and are properly allocable to or chargeable against items of capital gain as defined in this section; 49

(4) The term "capital net gain" means the excess of the

Illustrated in Problem:

total amount of capital gain over the sum of the capital deductions and
49 tions and capital losses;

50 (5) The term "ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions; and

(6) The term "capital assets" as used in this section means
51 property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

52 (b) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected
53 and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:

A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

(c) In the case of a partnership or of an estate or trust,
54 the proper part of each share of the net income which consists, respectively, of ordinary net income and capital net gain, shall be determined under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary, and shall be separately shown in the return of the partnership or estate or trust, and shall be taxed to the member or beneficiary or to the estate or trust as provided in sections

218 and 219, but at the rates and in the manner provided in subdivision (b) of this section. *Illustrated in Problem:*

Part II.—Individuals

NORMAL TAX

Sec. 210. That, in lieu of the tax imposed by section 210 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax of 8 per centum of the amount of the net income in excess of the credits provided in section 216: *Provided*, That in the case of a citizen or resident of the United States the rate upon the first $4,000 of such excess amount shall be 4 per centum. 55

SURTAX

Sec. 211. (a) That, in lieu of the tax imposed by section 211 of the Revenue Act of 1918, but in addition to the normal tax imposed by section 210 of this Act, there shall be levied, collected, and paid for each taxable year upon the net income of every individual— 56

(1) For the calendar year 1921, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $5,000 and does not exceed $6,000;

2 per centum of the amount by which the net income exceeds $6,000 and does not exceed $8,000;

3 per centum of the amount by which the net income exceeds $8,000 and does not exceed $10,000;

4 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

5 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

6 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

7 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

8 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

9 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

10 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

11 per centum of the amount by which the net income exceeds $24,000 and does not exceed 26,000;

12 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

13 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

14 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $34,000;

16 per centum of the amount by which the net income exceeds $34,000 and does not exceed $36,000;

17 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

18 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

19 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

20 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

21 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

22 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

23 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

24 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

25 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

26 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

27 per centum of the amount by which the net income exceeds $56,000 and does not exceed $58,000;

28 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

29 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

30 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

31 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

32 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

33 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

34 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

35 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

36 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

37 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

38 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

39 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

40 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

41 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

42 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

43 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

Illustrated in Problem:

44 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

45 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

46 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000;

47 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

48 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

52 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

56 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

60 per centum of the amount by which the net income exceeds $200,000 and does not exceed $300,000;

63 per centum of the amount by which the net income exceeds $300,000 and does not exceed $500,000;

64 per centum of the amount by which the net income exceeds $500,000 and does not exceed $1,000,000;

65 per centum of the amount by which the net income exceeds $1,000,000;

56 (2) For the calendar year 1922 and each calendar year thereafter, a surtax equal to the sum of the following:

1 per centum of the amount by which the net income exceeds $6,000 and does not exceed $10,000;

2 per centum of the amount by which the net income exceeds $10,000 and does not exceed $12,000;

3 per centum of the amount by which the net income exceeds $12,000 and does not exceed $14,000;

4 per centum of the amount by which the net income exceeds $14,000 and does not exceed $16,000;

5 per centum of the amount by which the net income exceeds $16,000 and does not exceed $18,000;

6 per centum of the amount by which the net income exceeds $18,000 and does not exceed $20,000;

8 per centum of the amount by which the net income exceeds $20,000 and does not exceed $22,000;

9 per centum of the amount by which the net income exceeds $22,000 and does not exceed $24,000;

10 per centum of the amount by which the net income exceeds $24,000 and does not exceed $26,000;

11 per centum of the amount by which the net income exceeds $26,000 and does not exceed $28,000;

12 per centum of the amount by which the net income exceeds $28,000 and does not exceed $30,000;

13 per centum of the amount by which the net income exceeds $30,000 and does not exceed $32,000;

15 per centum of the amount by which the net income exceeds $32,000 and does not exceed $36,000;

16 per centum of the amount by which the net income exceeds $36,000 and does not exceed $38,000;

17 per centum of the amount by which the net income exceeds $38,000 and does not exceed $40,000;

18 per centum of the amount by which the net income exceeds $40,000 and does not exceed $42,000;

19 per centum of the amount by which the net income exceeds $42,000 and does not exceed $44,000;

20 per centum of the amount by which the net income exceeds $44,000 and does not exceed $46,000;

21 per centum of the amount by which the net income exceeds $46,000 and does not exceed $48,000;

22 per centum of the amount by which the net income exceeds $48,000 and does not exceed $50,000;

23 per centum of the amount by which the net income exceeds $50,000 and does not exceed $52,000;

24 per centum of the amount by which the net income exceeds $52,000 and does not exceed $54,000;

25 per centum of the amount by which the net income exceeds $54,000 and does not exceed $56,000;

26 per centum of the amount by which the net income exceeds $56,000 and does exceed $58,000;

27 per centum of the amount by which the net income exceeds $58,000 and does not exceed $60,000;

28 per centum of the amount by which the net income exceeds $60,000 and does not exceed $62,000;

29 per centum of the amount by which the net income exceeds $62,000 and does not exceed $64,000;

30 per centum of the amount by which the net income exceeds $64,000 and does not exceed $66,000;

31 per centum of the amount by which the net income exceeds $66,000 and does not exceed $68,000;

32 per centum of the amount by which the net income exceeds $68,000 and does not exceed $70,000;

33 per centum of the amount by which the net income exceeds $70,000 and does not exceed $72,000;

34 per centum of the amount by which the net income exceeds $72,000 and does not exceed $74,000;

35 per centum of the amount by which the net income exceeds $74,000 and does not exceed $76,000;

36 per centum of the amount by which the net income exceeds $76,000 and does not exceed $78,000;

37 per centum of the amount by which the net income exceeds $78,000 and does not exceed $80,000;

38 per centum of the amount by which the net income exceeds $80,000 and does not exceed $82,000;

39 per centum of the amount by which the net income exceeds $82,000 and does not exceed $84,000;

40 per centum of the amount by which the net income exceeds $84,000 and does not exceed $86,000;

41 per centum of the amount by which the net income exceeds $86,000 and does not exceed $88,000;

42 per centum of the amount by which the net income exceeds $88,000 and does not exceed $90,000;

43 per centum of the amount by which the net income exceeds $90,000 and does not exceed $92,000;

44 per centum of the amount by which the net income exceeds $92,000 and does not exceed $94,000;

45 per centum of the amount by which the net income exceeds $94,000 and does not exceed $96,000; *Illustrated in Problem:*

46 per centum of the amount by which the net income exceeds $96,000 and does not exceed $98,000;

47 per centum of the amount by which the net income exceeds $98,000 and does not exceed $100,000;

48 per centum of the amount by which the net income exceeds $100,000 and does not exceed $150,000;

49 per centum of the amount by which the net income exceeds $150,000 and does not exceed $200,000;

50 per centum of the amount by which the net income exceeds $200,000.

(b) In the case of a bona fide sale of mines, oil or gas wells, 57
or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and 58
discovery work done by the taxpayer, the portion of the tax imposed by this section attributable to such sale shall not exceed, for the calendar year 1921, 20 per centum, and for each calendar year thereafter 16 per centum, of the selling price of such property or interest.

NET INCOME OF INDIVIDUALS DEFINED

SEC. 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 59
213, less the deduction allowed by section 214.

(b) The net income shall be computed upon the basis of 59
the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200, or if the taxpayer has no annual accounting period or

Illustrated in Problem: does not keep books, the net income shall be computed on the basis of the calendar year.

60 (c) If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

GROSS INCOME DEFINED

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

61 (a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the
62 Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the
63 United States, Alaska, Hawaii, or any political subdivision there-
64 of, or the District of Columbia, the compensation received as
65 such), of whatever kind and in whatever form paid, or from
66 professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

67 (1) The proceeds of life insurance policies paid upon the death of the insured;

(2) The amount received by the insured as a return of

premium or premiums paid by him under life insurance, en- *Illustrated in Problem:*
dowment, or annuity contracts, either during the term or at 68
the maturity of the term mentioned in the contract or upon surrender of the contract;

(3) The value of property acquired by gift, bequest, de- 69
vise or descent (but the income of such property shall be included in gross income);

(4) Interest upon (a) the obligations of a State, Territory, 70
or any political subdivision thereof, or the District of Columbia; or (b) securities issued under the provisions of the Federal
Farm Loan Act of July 17, 1916; or (c) the obligations of the 72
United States or its possessions; or (d) bonds issued by the
War Finance Corporation. In the case of obligations of the 71
United States issued after September 1, 1917 (other than postal savings certificates of deposit), and in the case of bonds issued by the War Finance Corporation, the interest shall be exempt only if and to the extent provided in the respective Acts authorizing the issue thereof as amended and supplemented, and shall be excluded from gross income only if and to the extent it is wholly exempt to the taxpayer from income, war-profits and excess-profits taxes;

(5) The income of foreign governments received from invest- 73
ments in the United States in stocks, bonds, or other domestic securities, owned by such foreign governments, or from interest on deposits in banks in the United States of moneys belonging to such foreign governments, or from any other source within the United States;

(6) Amounts received, through accident or health insurance 74
or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sickness;

(7) Income derived from any public utility or the exercise 75
of any essential governmental function and accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, or income accruing to

Illustrated in Problem:

the Government of any possession of the United States, or any political subdivision thereof.

Whenever any State, Territory, or the District of Columbia, or any political subdivision of a State or Territory, prior to September 8, 1916, entered in good faith into a contract with any person, the object and purpose of which is to acquire, construct, operate, or maintain a public utility, no tax shall be levied under the provisions of this title upon the income derived from the operation of such public utility, so far as the payment thereof will impose a loss or burden upon such State, Territory, District of Columbia, or political subdivision; but this provision is not intended and shall not be construed to confer upon such person any financial gain or exemption or to relieve such person from the payment of a tax as provided for in this title upon the part or portion of such income to which such person is entitled under such contract;

(8) The income of a non-resident alien or foreign corpora-
76 tion which consists exclusively of earnings derived from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States;

(9) Amounts received as compensation, family allotments
77 and allowances under the provisions of the War Risk Insurance and the Vocational Rehabilitation Acts, or as pensions from the United States for service of the beneficiary or another in the military or naval forces of the United States in time of war;

(10) So much of the amount received by an individual after
78 December 31, 1921, and before January 1, 1927, as dividends or interest from domestic building and loan associations, operated exclusively for the purpose of making loans to members, as does not exceed $300;

(11) The rental value of a dwelling house and appurten-
79 ances thereof furnished to a minister of the gospel as part of his compensation;

(12) The receipts of shipowners' mutual protection and in-

demnity associations, not organized for profit, and no part of *Illustrate in Probler*
the net earnings of which inures to the benefit of any private
stockholder or member but such corporations shall be subject **80**
as other persons to the tax upon their net income from interest,
dividends, and rents.

(c) In the case of a nonresident alien individual, gross **81**
income means only the gross income from sources within the
United States, determined under the provisions of section 217.

DEDUCTIONS ALLOWED INDIVIDUALS

Sec. 214. (a) That in computing net income there shall be
allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred **82, 89**
during the taxable year in carrying on any trade or busi- **83, 90**
ness, including a reasonable allowance for salaries or other com- **84, 91**
pensation for personal services actually rendered; traveling **85, 92**
expenses (including the entire amount expended for meals and **86, 93**
lodging) while away from home in the pursuit of a trade or
business; and rentals or other payments required to be made **87, 97**
as a condition to the continued use or possession for purposes of
the trade or business, of property to which the taxpayer has **88, 137**
not taken or is not taking title or in which he has no equity;

(2) All interest paid or accrued within the taxable year on
indebtedness, except on indebtedness incurred or continued
to purchase or carry obligations or securities (other than obli-
gations of the United States issued after September 24, 1917, **94**
and originally subscribed for by the taxpayer) the interest **95**
upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except (a) **97, 138**
income, war-profits, and excess-profits taxes imposed by the
authority of the United States, (b) so much of the income, **100**
war-profits and excess-profits taxes, imposed by the authority **101**
of any foreign country or possession of the United States,
as is allowed as a credit under section 222, (c) taxes assessed **102**
against local benefits of a kind tending to increase the value of **96**
the property assessed, and (d) taxes imposed upon the tax-
payer upon his interest as shareholder or member of a cor-

Illustrated in Problem: poration, which are paid by the corporation without reimbursement from the taxpayer. For the purpose of this paragraph
98 estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

103, 114, 117 (4) Losses sustained during the taxable year and not com-
104, 115, 118 pensated for by insurance or otherwise, if incurred in trade or business;

(5) Losses sustained during the taxable year and not com-
104, 109 pensated for by insurance or otherwise, if incurred in any
108, 110 transaction entered into for profit (though not connected with the trade or business; but in the case of a nonresident alien individual only if and to the extent that the profit, if such transaction had resulted in a profit, would be taxable under
105 this title. No deduction shall be allowed under this paragraph for any loss claimed to have been sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or in-
106 heritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition. If such acquisition is to the extent of
107 part only of substantially identical property, then only a proportionate part of the loss shall be disallowed;

(6) Losses sustained during the taxable year of property
112 not connected with the trade or business (but in the case of
111 a nonresident alien individual only property within the United
116 States) if arising from fires, storms, shipwreck, or other casualty, or from theft, and if not compensated for by insurance or otherwise. Losses allowed under paragraphs (4), (5), and
113 (6) of this subdivision shall be deducted as of the taxable year in which sustained unless, in order to clearly reflect the income, the loss should, in the opinion of the Commissioner, be accounted for as of a different period. In case of losses arising from destruction of or damage to property, where the property
111 so destroyed or damaged was acquired before March 1, 1913,

the deduction shall be computed upon the basis of its fair *Illustrated in Problem:*
market price or value as of March 1, 1913;

(7) Debts ascertained to be worthless and charged off within
the taxable year (or, in the discretion of the Commissioner, a **119**
reasonable addition to a reserve for bad debts); and when sat-
isfied that a debt is recoverable only in part, the Commissioner
may allow such debt to be charged off in part;

(8) A reasonable allowance for the exhaustion, wear and tear **120, 123**
of property used in the trade or business, including a reason- **121, 124**
able allowance for obsolescence. In the case of such property
acquired before March 1, 1913, this deduction shall be com- **122, 125**
puted upon the basis of its fair market price or value as of
March 1, 1913;

(9) In the case of buildings, machinery, equipment, or other **126**
facilities, constructed, erected, installed, or acquired, on or after
April 6, 1917, for the production of articles contributing to **128**
the prosecution of the war against the German Government,
and in the case of vessels constructed or acquired on or after
such date for the transportation of articles or men contribut-
ing to the prosecution of such war, there shall be allowed, for
any taxable year ending before March 3, 1924 (if claim therefor
was made at the time of filing return for the taxable year
1918, 1919, 1920, or 1921) a reasonable deduction for the amor-
tization of such part of the cost of such facilities or vessels
as has been borne by the taxpayer, but not again including
any amount otherwise allowed under this title or previous Act
of Congress as a deduction in computing net income. At any
time before March 3, 1924, the Commissioner may, and at the **127**
request of the taxpayer shall, reexamine the return, and if he
then finds as a result of an appraisal or from other evidence
that the deduction originally allowed was incorrect, the income,
war-profits, and excess-profits taxes for the year or years
affected shall be redetermined; and the amount of tax due
upon such redetermination, if any, shall be paid upon notice
and demand by the collector, or the amount of tax overpaid,
if any, shall be credited or refunded to the taxpayer in ac-
cordance with the provisions of section 252;

Illustrated in Problem:

(10) In the case of mines, oil and gas wells, other natural
129 deposits, and timber, a reasonable allowance for depletion and
130 for depreciation of improvements, according to the peculiar
135 conditions in each case, based upon cost including
cost of development not otherwise deducted: *Provided,* That
in the case of such properties acquired prior to March 1, 1913,
133 the fair market value of the property (or the taxpayer's in-
134 terest therein) on that date shall be taken in lieu of cost up
to that date: *Provided further,* That in the case of mines, oil
and gas wells, discovered by the taxpayer, on or after March
1, 1913, and not acquired as the result of purchase of a proven
131 tract or lease, where the fair market value of the property is
materially disproportionate to the cost, the depletion allowance
shall be based upon the fair market value of the property at
the date of discovery, or within thirty days thereafter: *And
132 provided further,* That such depletion allowance based on dis-
covery value shall not exceed the net income, computed with-
out allowance for depletion, from the property upon which the
discovery is made, except where such net income so computed
is less than the depletion allowance based on cost or fair market
value as of March 1, 1913; such reasonable allowance in all
the above cases to be made under rules and regulations to
be prescribed by the Commissioner, with the approval of the
Secretary. In the case of leases the deductions allowed by this
paragraph shall be equitably apportioned between the lessor
and lessee;

(11) Contributions or gifts made within the taxable year to
136 or for the use of: (A) The United States, any State, Terri-
tory, or any political subdivision thereof, or the District of
Columbia, for exclusively public purposes; (B) any corpora-
tion, or community chest, fund, or foundation, organized and
operated exclusively for religious, charitable, scientific, liter-
ary, or educational purposes, including posts of the American
Legion or the women's auxiliary units thereof, or for the pre-
vention of cruelty to children or animals, no part of the net
earnings of which inures to the benefit of any private stock-
holder or individual; or (C) the special fund for vocational

Illustrated in Problem:

rehabilitation authorized by section 7 of the Vocational Rehabilitation Act; to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this paragraph. In case of a nonresident alien individual this deduction shall be alowed only as to contributions or gifts made to domestic corporations, or to community chests, funds, or foundations, created in the United States, or to such vocational rehabilitation fund. Such contributions or gifts shall be allowable as deductions only if verified under rules and regulations prescribed by the Commissioner, with the approval of the Secretary;

(12) If property is compulsorily or involuntarily converted **30**
into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax acts.

(b) In the case of a nonresident alien individual, the deductions allowed in subdivision (a), except those allowed in paragraphs (5), (6), and (11), shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and

Illustrated in Problem: allocation of the deductions with respect to sources of income within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary. In the case of a citizen entitled to the benefits of section 262 the deductions shall be the same and shall be determined in the same manner as in the case of a nonresident alien individual.

ITEMS NOT DEDUCTIBLE

138, 141 SEC. 215. (a) That in computing net income no deduction
139, 142 shall in any case be allowed in respect of—

140, 143 (1) Personal, living, or family expenses;

144, 147 (2) Any amount paid out for new buildings or for per-
145, 148 manent improvements or betterments made to increase the value
146 of any property or estate;

149 (3) Any amount expended in restoring property or in mak-
150 ing good the exhaustion thereof for which an allowance is or has been made; or

(4) Premiums paid on any life insurance policy covering the
151 life of any officer or employee, or of any person financially interested in any trade or business carried on by the taxpayer, when the taxpayer is directly or indirectly a beneficiary under such policy.

(b) Amounts paid under the laws of any State, Territory, District of Columbia, possession of the United States, or foreign country as income to the holder of a life or terminable in-
152 terest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time, nor by any deduction allowed by this Act for the purpose of computing the net income of an estate or trust but not allowed under the laws of such State, Territory, District of Columbia, possession of the United States, or foreign country for the purpose of computing the income to which such holder is entitled.

CREDITS ALLOWED INDIVIDUALS

SEC. 216. That for the purpose of the normal tax only there *Illustrated in Problem:*
shall be allowed the following credits:

(a) The amount received as dividends (1) from a domestic 153
corporation other than a corporation entitled to the benefits 169
of section 262, or (2) from a foreign corporation when it is
shown to the satisfaction of the Commissioner that more than
50 per centum of the gross income of such foreign corporation
for the three-year period ending with the close of its taxable
year preceding the declaration of such dividends (or for such
part of such period as the corporation has been in existence)
was derived from sources within the United States as deter-
mined under the provisions of section 217;

(b) The amount received as interest upon obligations of the 169
United States and bonds issued by the War Finance Corpora- 218
tion, which is included in gross income under section 213;

(c) In the case of a single person, a personal exemption 154
of $1,000; or in the case of the head of a family or a married 155
person living with husband or wife, a personal exemption of
$2,500, unless the net income is in excess of $5,000, in which
case the personal exemption shall be $2,000. A husband and 190
wife living together shall receive but one personal exemption.
The amount of such personal exemption shall be $2,500, unless
the aggregate net income of such husband and wife is in ex-
cess of $5,000, in which case the amount of such personal
exemption shall be $2,000. If such husband and wife make
separate returns, the personal exemption may be taken by
either or divided between them. In no case shall the reduc-
tion of the personal exemption from $2,500 to $2,000 oper-
ate to increase the tax, which would be payable if the exemption
were $2,500, by more than the amount of the net income in
excess of $5,000;

(d) $400 for each person (other than husband or wife) de- 154
pendent upon and receiving his chief support from the tax- 155
payer if such dependent person is under eighteen years of age 156

Illustrated in Problem:

or is incapable of self-support because mentally or physically defective.

(e) In the case of a nonresident alien individual or of a
157 citizen entitled to the benefits of section 262, the personal exemption shall be only $1,000, and he shall not be entitled to the credit provided in subdivision (d).

(f) The credits allowed by subdivisions (c), (d) and (e) of
158 this section shall be determined by the status of the taxpayer on the last day of the period for which the return of income is made; but in the case of an individual who dies during the taxable year, such credits shall be determined by his status at the time of his death, and in such case full credits shall be allowed to the surviving spouse, if any, according to his or her status at the close of the period for which such survivor makes return of income.

NET INCOME OF NONRESIDENT ALIEN INDIVIDUALS

SEC. 217. (a) That in the case of a nonresident alien individual or of a citizen entitled to the benefits of Section 252 the following items of gross income shall be treated as income from sources within the United States:

159 (1) Interest on bonds, notes, or other interest-bearing obli-
160 gations of residents, corporate or otherwise, not including (A) interest on deposits with persons carrying on the banking business paid to persons not engaged in business within the United States and not having an office or place of business therein, or (B) interest received from a resident alien individual or a resident foreign corporation when it is shown to the satisfaction of the Commissioner that less than 20 per centum of the gross income of such resident payor has been derived from sources within the United States, as determined under the provisions of this section, for the three-year period ending with the close of the taxable year of such payor, or for such part of such period immediately preceding the close of such taxable year as may be applicable;

161 (2) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the bene-

fits of section 262, or (B) from a foreign corporation unless less than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the corporation has been in existence) was derived from sources within the United States as determined under the provisions of this section; *Illustrated in Problem:*

(3) Compensation for labor or personal services performed in the United States;

(4) Rentals or royalties from property located in the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using in the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located in the United States.

(b) From the items of gross income specified in subdivi- **162**
sion (a) there shall be deducted the expenses, losses, and other **163**
deductions properly apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States.

(c) The following items of gross income shall be treated as income from sources without the United States:

(1) Interest other than that derived from sources within the United States as provided in paragraph (1) of subdivision (a);

(2) Dividends other than those derived from sources within the United States as provided in paragraph (2) of subdivision (a);

(3) Compensation for labor or personal service performed without the United States;

(4) Rentals or royalties from property located without the United States or from any interest in such property, including rentals or royalties for the use of or for the privilege of using

without the United States, patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property; and

(5) Gains, profits, and income from the sale of real property located without the United States;

(d) From the items of gross income specified in subdivision (c) there shall be deducted the expenses, losses, and other deductions properly apportioned or allocated thereto, and a ratable part of any expenses, losses, or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be treated in full as net income from sources without the United States.

(e) Items of gross income, expenses, losses and deductions, other than those specified in subdivisions (a) and (c), shall be allocated or apportioned to sources within or without the United States under rules and regulations prescribed by the Commissioner with the approval of the Secretary. Where items of gross income are separately allocated to sources within the United States, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the United States. In the case of gross income derived from sources partly within and partly without the United States, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which can not definitely be allocated to some item or class of gross income; and the portion of such net income attributable to sources within the United States may be determined by processes or formulas of general apportionment prescribed by the Commissioner with the approval of the Secretary. Gains, profits and income from (1) transportation or other services rendered partly within and partly without the United States, or (2)

Illustrated in Problem:

from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the United States, 164
or produced (in whole or in part) by the taxpayer without 165
and sold within the United States, shall be treated as derived partly from sources within and partly from sources without the United States. Gains, profits and income derived from the purchase of personal property within and its sale without the United States or from the purchase of personal property 166
without and its sale within the United States, shall be treated as derived entirely from the country in which sold.

(f) As used in this section the words "sale" or "sold" include "exchange" or "exchanged"; and the word "produced" includes "created," "fabricated," "manufactured," "extracted," "processed," "cured," or "aged."

(g) A nonresident alien individual or a citizen entitled to the benefits of section 262 shall receive the benefit of the deductions and credits allowed in this title only by filing or causing to be filed with the collector a true and accurate return of his total income received from all sources corporate or otherwise in the United States, in the manner prescribed in this title; including therein all the information which the Commissioner may deem necessary for the calculation of such deductions and credits: *Provided,* That the benefit of the credit allowed in subdivision (e) of section 216 may, in the discretion of the Commissioner, be received by filing a claim therefor with the withholding agent. In case of failure to file a return, the collector shall collect the tax on such income, and all property belonging to such nonresident alien individual or foreign trader shall be liable to distraint for the tax.

PARTNERSHIPS AND PERSONAL SERVICE CORPORATIONS

SEC. 218. (a) That individuals carrying on business in part- 167
nership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income 168
of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, or, if his net income for such taxable year is computed upon

Illustrated in Problem: the basis of a period different from that upon the basis of which the net income of the partnership is computed, then his distributive share of the net income of the partnership for any accounting period of the partnership ending within the fiscal or calendar year upon the basis of which the partner's net income is computed.

169 (b) The partner shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the partnership.

(c) The net income of the partnership shall be computed in the same manner and on the same basis as provided in section 212 except that the deduction provided in paragraph (11) of subdivision (a) of section 214 shall not be allowed.

170 (d) Personal service corporations shall not be subject to taxation under this title, but the individual stockholders thereof shall be taxed in the same manner as the members of partnerships. All the provisions of this title relating to partnerships and the members thereof shall so far as practicable apply to personal service corporations and the stockholders thereof: *Provided,* That for the purpose of this subdivision amounts distributed by a personal service corporation during its taxable year shall be accounted for by the distributees; and any portion of the net income remaining undistributed at the close of its taxable year shall be accounted for by the stockholders of such corporation at the close of its taxable year in proportion to their respective shares.

This subdivision shall not be in effect after December 31,
171 1921. In the case of a personal service corporation having a fiscal year beginning in 1921 and ending in 1922, amounts distributed prior to January 1, 1922, to its stockholders out of earnings or profits accumulated after December 31, 1920, shall be taxed to the distributees; and the stockholders of record on December 31, 1921, shall be taxed upon their distributive shares of the difference (if any) between such distributive profits and the portion of the corporation's net income assign-

Illustrated in Problem:

able to the calendar year 1921, determined in the manner provided in clause (1) of subdivision (c) of section 205 of this Act.

ESTATES AND TRUSTS

Sec. 219. (a) That the tax imposed by sections 210 and 211 shall apply to the income of estates or of any kind of property held in trust, including— 172

(1) Income received by estates of deceased persons during the period of administration or settlement of the estate;

(2) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests;

(3) Income held for future distribution under the terms of the will or trust; and

(4) Income which is to be distributed to the beneficiaries periodically, whether or not at regular intervals, and the income collected by a guardian of an infant to be held or distributed as the court may direct.

(b) The fiduciary shall be responsible for making the return of income for the estate or trust for which he acts. The net income of the estate or trust shall be computed in the same manner and on the same basis as provided in section 212, except that (in lieu of the deduction authorized by paragraph (11) of subdivision (a) of section 214) there shall also be allowed as a deduction, without limitation, any part of the gross income which, pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in paragraph (11) of subdivision (a) of section 214. In cases in which there is any income of the class described in paragraph (4) of subdivision (a) of this section the fiduciary shall include in the return a statement of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable to each beneficiary, whether or not distributed before the close of the taxable year for which the return is made. 172

(c) In cases under paragraphs (1), (2), or (3) of subdi-

vision (a) or in any other case within subdivision (a) of this section except paragraph (4) thereof the tax shall be imposed upon the net income of the estate or trust and shall be paid by the fiduciary, except that in determining the net income of the estate of any deceased person during the period of administration or settlement there may be deducted the amount of any income properly paid or credited to any legatee, heir or other beneficiary. In such cases the estate or trust shall, for the purpose of the normal tax, be allowed the same credits as are allowed to single persons under section 216.

(d) In cases under paragraph (4) of subdivision (a), and in the case of any income of an estate during the period of administration or settlement permitted by subdivision (c) to be deducted from the net income upon which tax is to be paid by the fiduciary, the tax shall not be paid by the fiduciary, but there shall be included in computing the net income of each beneficiary that part of the income of the estate or trust, for its taxable year which, pursuant to the instrument or order governing the distribution, is distributable to such beneficiary, whether distributed or not, or, if his taxable year is different from that of the estate or trust, then there shall be included in computing his net income his distributive share of the income of the estate or trust for its taxable year ending within the taxable year of the beneficiary. In such cases the beneficiary shall, for the purpose of the normal tax, be allowed as credits, in addition to the credits allowed to him under section 216, his proportionate share of such amounts specified in subdivisions (a) and (b) of section 216 as are received by the estate or trust.

(e) In the case of an estate or trust the income of which consists both of income of the class described in paragraph (4) of subdivision (a) of this section and other income, the net income of the estate or trust shall be computed and a return thereof made by the fiduciary in accordance with subdivision (b) and the tax shall be imposed, and shall be paid by the fiduciary in accordance with subdivision (c), except that there shall be allowed as an additional deduction in computing the

net income of the estate or trust that part of its income of the class described in paragraph (4) of subdivision (a) which, pursuant to the instrument or order governing the distribution, is distributable during its taxable year to the beneficiaries. In cases under this subdivision there shall be included, as provided in subdivision (d) of this section, in computing the net income of each beneficiary, that part of the income of the estate or trust which, pursuant to the instrument or order governing the distribution, is distributable during the taxable year to such beneficiary. *Illustrated in Problem:*

(f) A trust created by an employer as a part of a stock bonus or profit-sharing plan for the exclusive benefit of some or 173
all of his employees, to which contributions are made by such employer, or employees, or both, for the purpose of distributing to such employees the earnings and principal of the fund accumulated by the trust in accordance with such plan, shall not be taxable under this section, but the amount actually distributed or made available to any distributee shall be taxable to him in the year in which so distributed or made available to the extent that it exceeds the amounts paid in by him. Such distributees shall for the purpose of the normal tax be allowed as credits that part of the amount so distributed or made available as represents the items specified in subdivisions (a) and (b) of section 216.

EVASION OF SURTAXES BY INCORPORATION

Sec. 220. That if any corporation, however created or organ- 174
ized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its stockholders or members through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there shall be levied, collected, and paid for each taxable year upon the net income of such corporation a tax equal to 25 per centum of the amount thereof, which shall be in addition to the tax imposed by section 230 of this title and shall be computed, collected, and paid upon the same basis and in the same manner and subject to the same provisions of law, including penalties,

Illustrated in Problem: as that tax: *Provided,* That if all the stockholders or members of such corporation agree thereto, the Commissioner may, in lieu of all income, war-profits and excess-profits taxes imposed upon the corporation for the taxable year, tax the stockholders or members of such corporation upon their distributive shares in the net income of the corporation for the taxable year in the same manner as provided in subdivision (a) of section 218 in the case of members of a partnership. The fact that any corporation is a mere holding company, or that the gains and profits are permitted to accumulate beyond the reasonable needs of the business, shall be prima facie evidence of a purpose to escape the surtax; but the fact that the gains and profits are in any case permitted to accumulate and become surplus shall not be construed as evidence of a purpose to escape the tax in such case unless the Commissioner certifies that in his opinion such accumulation is unreasonable for the purposes of the business. When requested by the Commissioner, or any collector, every corporation shall forward to him a correct statement of such gains and profits and the names and addresses of the individuals or shareholders who would be entitled to the same if divided or distributed, and of the amounts that would be payable to each.

PAYMENT OF INDIVIDUAL TAX AT SOURCE

Sec. 221. (a) That all individuals, corporations, and part-
175 nerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, employers, and all officers and employees of the United States having the control, receipt, custody, disposal, or payment of interest (except interest on deposits with persons carrying on the banking business paid to persons not engaged in business in the United States and not having an office or place of business therein), rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable annual or periodical gains, profits, and income, of any nonresident alien individual or partnership composed in whole or in part of nonresident aliens (other than income received as dividends of the class allowed as a credit by subdivision (a) of section 216) shall

(except in the cases provided for in subdivision (b) and except as otherwise provided in regulations prescribed by the Commissioner under section 217) deduct and withhold from such annual or periodical gains, profits, and income a tax equal to 8 per centum thereof: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld from the interest upon any securities the owners of which are not known to the withholding agent. *Illustrated in Problem:*

(b) In any case where bonds, mortgages, or deeds of trust, 176
or other similar obligations of a corporation contain a contract or provision by which the obligor agrees to pay any portion of the tax imposed by this title upon the obligee, or to reimburse the obligee for any portion of the tax, or to pay the interest without deduction for any tax which the obligor may be required or permitted to pay thereon, or to retain therefrom under any law of the United States, the obligor shall deduct and withhold a tax equal to 2 per centum of the interest upon such bonds, mortgages, deeds of trust, or other obligations, whether such interest is payable annually or at shorter or longer periods and whether payable to a nonresident alien individual or to an individual citizen or resident of the United States or to a partnership: *Provided,* That the Commissioner may authorize such tax to be deducted and withheld in the case of interest upon any such bonds, mortgages, deeds of trust, or other obligations, the owners of which are not known to the withholding agent. Such deduction and withholding shall not be required in the case of a citizen or resident entitled to receive such interest, if he files with the withholding agent on or before February 1 a signed notice in writing claiming the benefit of the credits provided in subdivisions (c) and (d) of section 216; nor in the case of a nonresident alien individual if so provided for in regulations prescribed by the Commissioner under subdivision (g) of section 217.

(c) Every individual, corporation, or partnership required 177
to deduct and withhold any tax under this section shall make return thereof on or before March 1 of each year and shall on or before June 15 pay the tax to the official of the United

Illustrated in Problem: States Government authorized to receive it. Every such individual, corporation, or partnership is hereby made liable for such tax and is hereby indemnified against the claims and demands of any individual, corporation, or partnership for the amount of any payments made in accordance with the provisions of this section.

178 (d) Income upon which any tax is required to be withheld at the source under this section shall be included in the return of the recipient of such income, but any amount of tax so withheld shall be credited against the amount of income tax as computed in such return.

(e) If any tax required under this section to be deducted and
179 withheld is paid by the recipient of the income, it shall not be re-collected from the withholding agent; nor in cases in which the tax is so paid shall any penalty be imposed upon or collected from the recipient of the income or the withholding agent for failure to return or pay the same, unless such failure was fraudulent and for the purpose of evading payment.

CREDIT FOR TAXES IN CASE OF INDIVIDUALS

Sec. 222. (a) That the tax computed under Part II of this title shall be credited with:

(1) In the case of a citizen of the United States the amount
182 of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country or to any possession of the United States; and

180 (2) In the case of a resident of the United States, the amount of any such taxes paid during the taxable year to any possession of the United States; and

(3) In the case of an alien resident of the United States,
181 the amount of any such taxes paid during the taxable year to any foreign country, if the foreign country of which such alien resident is a citizen or subject, in imposing such taxes, allows a similar credit to citizens of the United States residing in such country; and

(4) In the case of any such individual who is a member of
180 a partnership or a beneficiary of an estate or trust, his propor-

tionate share of such taxes of the partnership or the estate *Illustrated in Problem:*
or trust paid during the taxable year to a foreign country or to any possession of the United States, as the case may be.

(5) The above credits shall not be allowed in the case of
a citizen entitled to the benefits of section 262; and in no other 182
case shall the amount of credit taken under this subdivision exceed the same proportion of the tax, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits and excess-profits taxes imposed by any foreign country or possession of the United States) from sources without the United States bears to his entire net income (computed without such deduction) for the same taxable year.

(b) If accrued taxes when paid differ from the amounts
claimed as credits by the taxpayer, or if any tax paid is re- 181
funded in whole or in part, the taxpayer shall notify the Commissioner, who shall redetermine the amount of the tax due under Part II of this title for the year or years affected, and the amount of tax due upon such redetermination, if any, shall be paid by the taxpayer upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the taxpayer to give a bond with sureties satisfactory to and to be approved by the Commissioner in such penal sum as the Commissioner may require, conditioned for the payment by the taxpayer of any amount of tax found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer fur- 186
nishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credits.

(d) If the taxpayer makes a return for a fiscal year begin- 187

Illustrated in Problem:

ning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or part, any such credit which he finds has already been taken by the taxpayer.

INDIVIDUAL RETURNS

Sec. 223. (a) That the following individuals shall each make under oath a return stating specifically the items of his gross income and the deductions and credits allowed under this title—

188 (1) Every individual having a net income for the taxable year of $1,000 or over, if single, or if married and not living with husband or wife;

190 (2) Every individual having a net income for the taxable year of $2,000 or over, if married and living with husband or wife; and

189 (3) Every individual having a gross income for the taxable year of $5,000 or over, regardless of the amount of his net income.

191 (b) If a husband and wife living together have an aggregate net income for the taxable year of $2,000 or over, or an aggregate gross income for such year of $5,000 or over—

(1) Each shall make such a return, or

191 (2) The income of each shall be included in a single joint return, in which case the tax shall be computed on the aggregate income.

(c) If the taxpayer is unable to make his own return, the
192 return shall be made by a duly authorized agent or by the guardian or other person charged with the care of the person or property of such taxpayer.

PARTNERSHIP RETURNS

Sec. 224. That every partnership shall make a return for each taxable year, stating specifically the items of its gross
193 income and the deductions allowed by this title, and shall include in the return the names and addresses of the individuals who would be entitled to share in the net income if distributed

and the amount of the distributive share of each individual. *Illustrated in Problem*
The return shall be sworn to by any one of the partners.

FIDUCIARY RETURNS

Sec. 225. (a) That every fiduciary (except a receiver ap-
pointed by authority of law in possession of part only of the 194
property of an individual) shall make under oath a return for 172
any of the following individuals, estates, or trusts for which he
acts, stating specifically the items of gross income thereof and
the deductions and credits allowed under this title—

(1) Every individual having a net income for the taxable 194
year of $1,000 or over, if single, or if married and not living
with husband or wife;

(2) Every individual having a net income for the taxable 194
year of $2,000 or over, if married and living with husband or
wife;

(3) Every individual having a gross income for the taxable 194
year of $5,000 or over, regardless of the amount of his net
income;

(4) Every estate or trust the net income of which for the 194
taxable year is $1,000 or over; and 172

(5) Every estate or trust of which any beneficiary is a non- 194
resident alien.

(b) Under such regulations as the Commissioner with the
approval of the Secretary may prescribe a return made by one 195
of two or more joint fiduciaries and filed in the office of the
collector of the district where such fiduciary resides shall be
sufficient compliance with the above requirement. Such fidu-
ciary shall make oath (1) that he has sufficient knowledge of the
affairs of the individual, estate or trust for which the return
is made, to enable him to make the return, and (2) that the
return is, to the best of his knowledge and belief, true and cor-
rect. Any fiduciary required to make a return under this Act
shall be subject to all the provisions of this Act which apply
to individuals.

Illustrated in Problem:

RETURNS FOR A PERIOD OF LESS THAN TWELVE MONTHS

Sec. 226. (a) That if a taxpayer, with the approval of the
Commissioner, changes the basis of computing net income from
60 fiscal year to calendar year a separate return shall be made
for the period between the close of the last fiscal year for which return was made and the following December 31. If the change is from calendar year to fiscal year, a separate return shall be made for the period between the close of the last calendar year for which return was made and the date designated as the close of the fiscal year. If the change is from one fiscal year to another fiscal year a separate return shall be made for the period between the close of the former fiscal year and the date designated as the close of the new fiscal year.

60 (b) In all cases where a separate return is made for a part of a taxable year the net income shall be computed on the basis of such period for which separate return is made, and the tax shall be paid thereon at the rate for the calendar year in which such period is included.

196 (c) In the case of a return for a period of less than one
year the net income shall be placed on an annual basis by mul-
197 tiplying the amount thereof by twelve and dividing by the num-
ber of months included in such period; and the tax shall be such part of a tax computed on such annual basis as the number of months in such period is of twelve months.

TIME AND PLACE FOR FILING INDIVIDUAL, PARTNERSHIP, AND FIDUCIARY RETURNS

198 Sec. 227. (a) That returns (except in the case of nonresident aliens) shall be made on or before the fifteenth day of the third month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before the 15th day of March. In the case of a nonresident alien individual returns shall be made on or before the fifteenth day of the sixth month following the close of the fiscal year, or, if the return is made on the basis of the calendar year, then the return shall be made on or before

the 15th day of June. The Commissioner may grant a reasonable extension of time for filing returns whenever in his judgment good cause exists and shall keep a record of every such extension and the reason therefor. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months. *Illustrated in Problem:*

(b) Returns shall be made to the collector for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

UNDERSTATEMENT IN RETURNS

Sec. 228. That if the collector or deputy collector has reason 200
to believe that the amount of any income returned is understated, he shall give due notice to the taxpayer making the return to show cause why the amount of the return should not be increased, and upon proof of the amount understated, may increase the same accordingly. Such taxpayer may furnish sworn testimony to prove any relevant facts and if dissatisfied with the decision of the collector may appeal to the Commissioner for his decision, under such rules of procedure as may be prescribed by the Commissioner with the approval of the Secretary.

INCORPORATION OF INDIVIDUAL OR PARTNERSHIP BUSINESS.

Sec. 229. That in the case of the organization as a corporation within four months after the passage of this act of any 201
trade or business in which capital is a material income-producing factor, and which was previously owned by a partnership or individual, the net income of such trade or business from January 1, 1921, to the date of such organization may at the option of the individual or partnership be taxed as the net income of a corporation is taxed under Titles II and III; in which event the net income and invested capital of such trade or business shall be computed as if such corporation had been in existence on and after January 1, 1921, and the undistributed

Illustrated in Problem: profits or earnings of such trade or business shall not be subject to the surtaxes imposed in section 211, but amounts distributed on and after January 1, 1921, from the earnings or profits of such trade or business accumulated after December 31, 1920, shall be taxed to the recipients as dividends; and all the provisions of Titles II and III relating to corporations shall so far as practicable apply to such trade or business: *Provided,* That this section shall not apply to any trade or business, the net income of which for the taxable year 1921 was less than 20 per centum of its invested capital for such year: *Provided further,* That any taxpayer who takes advantage of this section shall pay the tax imposed by section 1000 of the Revenue Act of 1918 as if such taxpayer had been a corporation on and after January 1, 1921.

Part III.—Corporations

TAX ON CORPORATIONS

202 Sec. 230. That, in lieu of the tax imposed by section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

CONDITIONAL AND OTHER EXEMPTIONS OF CORPORATIONS

Sec. 231. That the following organizations shall be exempt from taxation under this title—

203 (1) Labor, agricultural, or horticultural organizations;

204 (2) Mutual savings banks not having a capital stock represented by shares;

205 (3) Fraternal beneficiary societies, orders, or associations, (a) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under

the lodge system; and (b) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents; *Illustrated in Problem:*

(4) Domestic building and loan associations substantially all the business of which is confined to making loans to members; and co-operative banks without capital stock organized and operated for mutual purposes and without profit; 206

(5) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, no part of the net earnings of which inures to the benefit of any private stockholder or individual; 207

(6) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private stockholder or individual; 208

(7) Business leagues, chambers of commerce, or boards of trade, not organized for profit and no part of the net earnings of which inures to the benefit of any private stockholder or individual;

(8) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare; 209

(9) Clubs organized and operated exclusively for pleasure, recreation, and other nonprofitable purposes, no part of the net earnings of which inures to the benefit of any private stockholder or member; 210

(10) Farmers' or other mutual hail, cyclone, or fire insurance companies, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations of a purely local character, the income of which consists solely of assessments, dues, and fees collected from members for the sole purpose of meeting expenses; 211

(11) Farmers', fruit growers', or like associations, organized

Illustrated in Problem:
and operated as sales agents for the purpose of marketing the
212 products of members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of produce furnished by them; or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses;

213 (12) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt from the tax imposed by this title;

(13) Federal land banks and national farm-loan associations
214 as provided in section 26 of the Act approved July 17, 1916, entitled "An Act to provide capital for agricultural development, to create standard forms of investment based upon farm mortgage, to equalize rates of interest upon farm loans, to furnish a market for United States bonds, to create Government depositaries and financial agents for the United States, and for other purposes";

1 (14) Personal service corporations. This subdivision shall not be in effect after December 31, 1921.

NET INCOME OF CORPORATIONS DEFINED

Sec. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the computation shall also be made in the manner provided in section 217.

GROSS INCOME OF CORPORATIONS DEFINED

Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term "gross income" means

the gross income as defined in sections 213 and 217, except *Illustrated in Problem:*
that mutual marine insurance companies shall include in gross
income the gross premiums collected and received by them less 215
amounts paid for reinsurance.

(b) In the case of a foreign corporation, gross income means
only gross income from sources within the United States, deter- 161
mined (except in the case of insurance companies subject to
the tax imposed by sections 243 or 246) in the manner provided 216
in section 217.

DEDUCTIONS ALLOWED CORPORATIONS

Sec. 234. (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other
compensation for personal services actually rendered, and in- 93
cluding rentals or other payments required to be made as a 82
condition to the continued use or possession of property to 97
which the corporation has not taken or is not taking title, or in 137
which it has no equity;

(2) All interest paid or accrued within the taxable year on
its indebtedness, except on indebtedness incurred or continued 94
to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;

(3) Taxes paid or accrued within the taxable year except 100
(a) income, war-profits, and excess-profits taxes imposed by the authority of the United States, (b) so much of the income, war-
profits and excess-profits taxes imposed by the authority of any 102
foreign country or possession of the United States as is allowed
as a credit under section 238, and (c) taxes assessed against 96
local benefits of a kind tending to increase the value of the 97
property assessed. In the case of obligors specified in sub-
division (b) of section 221 no deduction for the payment of 99

Illustrated in Problem: the tax imposed by this title, or any other tax paid pursuant to the contract or provision referred to in that subdivision, shall be allowed nor shall such tax be included in the gross income of the obligee. The deduction allowed by this paragraph shall
98 be allowed in the case of taxes imposed upon a shareholder or member of a corporation upon his interest as shareholder or member, which are paid by the corporation without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes. For the purpose of this paragraph, estate, inheritance, legacy, and succession taxes accrue on the due date thereof except as otherwise provided by the law of the jurisdiction imposing such taxes;

103, 114, 117 (4) Losses sustained during the taxable year and not com-
111, 115, 118 pensated for by insurance or otherwise; unless, in order to clearly reflect the income, the loss should in the opinion of the Commissioner be accounted for as of a different period. No
31 deduction shall be allowed for any loss claimed to have been
106 sustained in any sale or other disposition of shares of stock or securities made after the passage of this Act where it appears that within thirty days before or after the date of such sale or other disposition the taxpayer has acquired (otherwise than by bequest or inheritance) substantially identical property, and the property so acquired is held by the taxpayer for any period after such sale or other disposition, unless such claim is made by a dealer in stock or securities and with respect to a trans-
106 action made in the ordinary course of its business. If such acquisition is to the extent of part only of substantially identical property, then only a proportionate part of the loss shall be disallowed. In case of losses arising from destruction of or
103 damage to property, where the property so destroyed or damaged was acquired before March 1, 1913, the deduction shall be
111 computed upon the basis of its fair market price or value as of March 1, 1913;

(5) Debts ascertained to be worthless and charged off within
119 the taxable year (or in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satis-

fied that a debt is recoverable only in part, the Commissioner *Illustrated in Problem:*
may allow such debt to be charged off in part;

(6) The amount received as dividends (A) from a domestic
corporation other than a corporation entitled to the benefits of 217
section 262, or (B) from any foreign corporation when it is
shown to the satisfaction of the Commissioner that more than 50
per centum of the gross income of such foreign corporation for
the three-year period ending with the close of its taxable year
preceding the declaration of such dividends (or for such part
of such period as the foreign corporation has been in existence)
was derived from sources within the United States as determined under section 217;

(7) A reasonable allowance for the exhaustion, wear and tear 120, 124
of property used in the trade or business, including a reasonable 121, 125
onable allowance for obsolescence. In the case of such property
acquired before March 1, 1913, this deduction shall be computed 122
upon the basis of its fair market price or value as of March 1, 123
1913;

(8) In the case of buildings, machinery, equipment, or other
facilities, constructed, erected, installed, or acquired, on or 126
after April 6, 1917, for the production of articles contributing
to the prosecution of the war against the German Government, 128
and in the case of vessels constructed or acquired on or after
such date for the transportation of articles or men contributing to the prosecution of such war, there shall be allowed, for
any taxable year ending before March 3, 1924 (if claim therefor was made at the time of filing return for the taxable year
1918, 1919, 1920, or 1921) a reasonable deduction for the amortization of such part of the cost of such facilities or vessels as
has been borne by the taxpayer, but not again including any
amount otherwise allowed under this title or previous Acts of
Congress as a deduction in computing net income. At any time 127
before March 3, 1924, the Commissioner may, and at the request
of the taxpayer shall, reexamine the return, and if he then finds
as a result of an appraisal or from other evidence that the deduction originally allowed was incorrect, the income, war-profits,
and excess-profits taxes for the year or years affected shall

Illustrated in Problem: be redetermined and the amount of tax due upon such redetermination, if any, shall be paid upon notice and demand by the collector, or the amount of tax overpaid, if any, shall be credited or refunded to the taxpayer in accordance with the provisions of section 252;

129 (9) In the case of mines, oil and gas wells, other natural de-
130 posits, and timber, a reasonable allowance for depletion and
for depreciation of improvements, according to the peculiar con-
135 ditions in each case, based upon cost including cost of develop-
ment not otherwise deducted: *Provided,* That in the case of such
133 properties acquired prior to March 1, 1913, the fair market
134 value of the property (or the taxpayer's interest therein) on
that date shall be taken in lieu of cost up to that date: *Pro-
vided further,* That in the case of mines, oil and gas wells, dis-
131 covered by the taxpayer, on or after March 1, 1913, and not
acquired as the result of purchase of a proven tract or lease,
where the fair market value of the property is materially dis-
proportionate to the cost, the depletion allowance shall be based
upon the fair market value of the property at the date of the
discovery, or within thirty days thereafter: *And provided fur-
132 ther,* That such depletion allowance based on discovery value
shall not exceed the net income, computed without allowance
for depletion, from the property upon which the discovery is
made, except where such net income so computed is less than the
depletion allowance based on cost or fair market value as of
March 1, 1913; such reasonable allowance in all the above cases
to be made under rules and regulations to be prescribed by the
Commissioner with the approval of the Secretary. In the case
of leases the deductions allowed by this paragraph shall be
equitably apportioned between the lessor and lessee;

(10) In the case of insurance companies (other than life insurance companies), in addition to the above (unless otherwise allowed): (A) The net addition required by law to be made within the taxable year to reserve funds (including in the case of assessment insurance companies the actual deposit of sums with State or Territorial officers pursuant to law as additions to guarantee or reserve funds); and (B) the sums other

Illustrated in Problem:

than dividends paid within the taxable year on policy and annuity contracts. After December 31, 1921, this subdivision shall apply only to mutual insurance companies other than life insurance companies;

(11) In the case of corporations (except those taxed under section 243) issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan continuing for life and not subject to cancellation, in addition to the above, such portion of the net addition (not required by law) made within the taxable year to reserve funds as the Commissioner finds to be required for the protection of the holders of such policies only. This subdivision shall not be in effect after December 31, 1921;

(12) In the case of mutual marine insurance companies, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, amounts repaid to policyholders on account of premiums previously paid by them, and interest paid upon such amounts between the ascertainment and the payment thereof;

(13) In the case of mutual insurance companies (including interinsurers and reciprocal underwriters, but not including mutual life or mutual marine insurance companies) requiring their members to make premium deposits to provide for losses and expenses, there shall be allowed, in addition to the deductions allowed in paragraphs (1) to (10), inclusive, and paragraph (14), unless otherwise allowed, the amount of premium deposits returned to their policyholders and the amount of premium deposits retained for the payment of losses, expenses, and reinsurance reserves;

(14) If property is compulsorily or involuntarily converted 30
into cash or its equivalent as a result of (A) its destruction in whole or in part, (B) theft or seizure, or (C) an exercise of the power of requisition or condemnation, or the threat or imminence thereof; and if the taxpayer proceeds forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, to expend the

Illustrated in Problem: proceeds of such conversion in the acquisition of other property of a character similar or related in service or use to the property so converted, or in the acquisition of 80 per centum or more of the stock or shares of a corporation owning such other property, or in the establishment of a replacement fund, then there shall be allowed as a deduction such portion of the gain derived as the portion of the proceeds so expended bears to the entire proceeds. The provisions of this paragraph prescribing the conditions under which a deduction may be taken in respect of the proceeds or gains derived from the compulsory or involuntary conversion of property into cash or its equivalent, shall apply so far as may be practicable to the exemption or exclusion of such proceeds or gains from gross income under prior income, war-profits and excess-profits tax Acts.

163 (b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the deductions allowed in subdivision (a) shall be allowed only if and to the extent that they are connected with income from sources within the United States; and the proper apportionment and allocation of the deductions with respect to sources within and without the United States shall be determined as provided in section 217 under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

ITEMS NOT DEDUCTIBLE BY CORPORATIONS

144 SEC. 235. That in computing net income no deduction shall in any case be allowed in respect of any of the items specified in section 215.

CREDITS ALLOWED CORPORATIONS

218 SEC. 236. That for the purpose only of the tax imposed by section 230 there shall be allowed the following credits:

(a) The amount received as interest upon obligations of the United States and bonds issued by the War Finance Corporation, which is included in gross income under section 233;

219 (b) In the case of a domestic corporation the net income of

which is $25,000 or less, a specific credit of $2,000; but if the *Illustrated in Problem:*
net income is more than $25,000 the tax imposed by section 220
230 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000; and

(c) The amount of any war-profits and excess-profits taxes 44
imposed by Act of Congress for the same taxable year. The credit allowed by this subdivision shall be determined as follows:

(1) In the case of a corporation which makes return for a fiscal year beginning in 1920 and ending in 1921, in computing the income tax as provided in subdivision (a) of section 205, the portion of the war-profits and excess-profits tax computed for the entire period under clause (1) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (a) of section 205, and the portion of the war-profits and excess-profits tax computed for the entire period under clause (2) of subdivision (a) of section 335 shall be credited against the net income computed for the entire period as provided in clause (2) of subdivision (a) of section 205.

(2) In the case of a corporation which makes return for 45
a fiscal year beginning in 1921 and ending in 1922, in computing the income tax as provided in subdivision (b) of section 205, the war-profits and excess-profits tax computed under subdivision (b) of section 335 shall be credited against the net income computed for the entire period as provided in clause (1) of subdivision (b) of section 205.

PAYMENT OF CORPORATION INCOME TAX AT SOURCE

SEC. 237. That in the case of foreign corporations subject to 221
taxation under this title not engaged in trade or business within the United States and not having any office or place of business therein, there shall be deducted and withheld at the source in the same manner and upon the same items of income as is provided in section 221 a tax equal to 12½ per

Illustrated in Problem: centum thereof (but during the calendar year 1921 only 10 per centum), and such tax shall be returned and paid in the same manner and subject to the same conditions as provided in that section: *Provided,* That in the case of interest described in subdivision (b) of that section the deduction and withholding shall be at the rate of 2 per centum.

CREDIT FOR TAXES IN CASE OF CORPORATIONS

183 SEC. 238. (a) That in the case of a domestic corporation the tax imposed by this title, plus the war-profits and excess-
184 profits taxes, if any, shall be credited with the amount of any income, war-profits, and excess-profits taxes paid during the same taxable year to any foreign country, or to any possession of the United States: *Provided,* That the amount of credit taken under this subdivision shall in no case exceed the same proportion of the taxes, against which such credit is taken, which the taxpayer's net income (computed without deduction for any income, war-profits, and excess-profits taxes imposed by any foreign country or possession of the United States) bears to its entire net income (computed without such deduction) for the same taxable year. In the case of domestic insurance companies subject to the tax imposed by section 243 or 246, the term "net income", as used in this subdivision means net income as defined in sections 245 and 246, respectively.

183 (b) If accrued taxes when paid differ from the amounts claimed as credits by the corporation, or if any tax paid is refunded in whole or in part, the corporation shall at once notify the Commissioner, who shall redetermine the amount of the income, war-profits and excess-profits taxes for the year or years affected, and the amount of taxes due upon such redetermination, if any, shall be paid by the corporation upon notice and demand by the collector, or the amount of taxes overpaid, if any, shall be credited or refunded to the corporation in accordance with the provisions of section 252. In the case of such a tax accrued but not paid, the Commissioner as a condition precedent to the allowance of this credit may require the corporation to give a bond with sureties satis-

Illustrated in Problem:

factory to and to be approved by him in such penal sum as he may require, conditioned for the payment by the taxpayer of any amount of taxes found due upon any such redetermination; and the bond herein prescribed shall contain such further conditions as the Commissioner may require.

(c) These credits shall be allowed only if the taxpayer furnishes evidence satisfactory to the Commissioner showing the amount of income derived from sources without the United States, and all other information necessary for the verification and computation of such credit. 186

(d) If a domestic corporation makes a return for a fiscal year beginning in 1920 and ending in 1921, the credit for the entire fiscal year shall, notwithstanding any provision of this Act, be determined under the provisions of this section; and the Commissioner is authorized to disallow, in whole or in part, any such credit which he finds has already been taken by the taxpayer. 187

(e) For the purposes of this section a domestic corporation which owns a majority of the voting stock of a foreign corporation from which it receives dividends (not deductible under section 234) in any taxable year shall be deemed to have paid the same proportion of any income, war-profits, or excess-profits taxes paid by such foreign corporation to any foreign country or to any possession of the United States, upon or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends bears to the amount of such accumulated profits: *Provided,* That the credit allowed to any domestic corporation under this subdivision shall in no case exceed the same proportion of the taxes against which it is credited, which the amount of such dividends bears to the amount of the entire net income of the domestic corporation in which such dividends are included. The term "accumulated profits" when used in this subdivision in reference to a foreign corporation, means the amount of its gains, profits, or income in excess of the income, war-profits, and excess-profits taxes imposed upon or with respect to such profits or income; and the Commissioner 185

Illustrated in Problem:

with the approval of the Secretary shall have full power to determine from the accumulated profits of what year or years such dividends were paid; treating dividends paid in the first sixty days of any year as having been paid from the accumulated profits of the preceding year or years (unless to his satisfaction shown otherwise), and in other respects treating dividends as having been paid from the most recently accumulated gains, profits, or earnings. In the case of a foreign corporation, the income, war-profits, and excess-profits taxes of which are determined on the basis of an accounting period of less than one year, the word "year" as used in this subdivision shall be construed to mean such accounting period.

(f) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation.

CORPORATION RETURNS

222 SEC. 239. (a) That every corporation subject to taxation under this title and every personal service corporation shall make a return, stating specifically the items of its gross income and the deductions and credits allowed by this title. The
223 return shall be sworn to by the president, vice president, or
225 other principal officer and by the treasurer or assistant treasurer. If any foreign corporation has no office or place of business in the United States but has an agent in the United States, the return shall be made by the agent. In cases where re-
224 ceivers, trustees in bankruptcy, or assignees are operating the property or business of corporations, such receivers, trustees, or assignees shall make returns for such corporations in the same manner and form as corporations are required to make returns. Any tax due on the basis of such returns made by receivers, trustees, or assignees shall be collected in the same manner as if collected from the corporations of whose business or property they have custody and control.

(b) Returns made under this section shall be subject to
219 the provisions of sections 226 and 228. When return is made under section 226 the credit provided in subdivision (b) of

section 236 shall be reduced to an amount which bears the *Illustrated in Problem:*
same ratio to the full credit therein provided as the number
of months in the period for which such return is made bears
to twelve months.

(c) There shall be included in the return or appended thereto
a statement of such facts as will enable the Commissioner to 226
determine the portion of the earnings or profits of the corpora-
tion (including gains, profits and income not taxed) accumu-
lated during the taxable year for which the return is made,
which have been distributed or ordered to be distributed, re-
spectively, to its stockholders or members during such year.

CONSOLIDATED RETURNS OF CORPORATIONS

SEC. 240. (a) That corporations which are affiliated within
the meaning of this section may, for any taxable year beginning 229
on or after January 1, 1922, make separate returns or, under
regulations prescribed by the Commissioner with the approval
of the Secretary, make a consolidated return of net income
for the purpose of this title, in which case the taxes there-
under shall be computed and determined upon the basis of
such return. If return is made on either of such bases, all re-
turns thereafter made shall be upon the same basis unless per-
mission to change the basis is granted by the Commissioner.

(b) In any case in which a tax is assessed upon the basis
of a consolidated return, the total tax shall be computed in 231
the first instance as a unit and shall then be assessed upon the
respective affiliated corporations in such proportions as may
be agreed upon among them, or, in the absence of any such agree-
ment, then on the basis of the net income properly assignable
to each. There shall be allowed in computing the income tax
only one specific credit computed as provided in subdivision
(b) of section 236.

(c) For the purpose of this section two or more domestic
corporations shall be deemed to be affiliated (1) if one cor- 227
poration owns directly or controls through closely affiliated
interest or by a nominee or nominees substantially all the
stock of the other or others, or (2) if substantially all the 228

Illustrated in Problem: stock of two or more corporations is owned or controlled by the same interests.

232 (d) For the purposes of this section a corporation entitled to the benefits of section 262 shall be treated as a foreign corporation: *Provided*, That in any case of two or more related trades or businesses (whether unincorporated or incorporated and whether organized in the United States or not) owned and controlled directly or indirectly by the same interests, the Commissioner may consolidate the accounts of such related trades or businesses, in any proper case, for the purpose of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses.

228 (e) Corporations which are affiliated within the meaning of
230 this section shall make consolidated returns for any taxable year beginning prior to January 1, 1922, in the same manner and subject to the same conditions as provided by the Revenue Act of 1918.

TIME AND PLACE FOR FILING CORPORATE RETURNS

198 SEC. 241. (a) That returns of corporations shall be made at the same time as is provided in subdivision (a) of section 227, except that in the case of foreign corporations not having any office or place of business in the United States returns shall be made at the same time as provided in section 227 in the case of a nonresident alien individual.

(b) Returns shall be made to the collector of the district in which is located the principal place of business or principal office or agency of the corporation, or, if it has no principal place of business or principal office or agency in the United States, then to the collector at Baltimore, Maryland.

TAXES ON INSURANCE COMPANIES

SEC. 242. That when used in this title the term "life insurance company" means an insurance company engaged in the business of issuing life insurance and annuity contracts (including contracts of combined life, health, and accident insur-

ance), the reserve funds of which held for the fulfillment of such contracts comprise more than 50 per centum of its total reserve funds. *Illustrated in Problem:*

SEC. 243. That in lieu of the taxes imposed by sections 230 and 1000 and by Title III, there shall be levied, collected, and paid for the calendar year 1921 and for each taxable year thereafter upon the net income of every life insurance company a tax as follows: 233

(1) In the case of a domestic life insurance company, the same percentage of its net income as is imposed upon other corporations by section 230;

(2) In the case of a foreign life insurance company, the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230. 234

SEC. 244. (a) That in the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents. 235

(b) The term "reserve funds required by law" includes, in the case of assessment insurance, sums actually deposited by any company or association with State or Territorial officers pursuant to law as guaranty or reserve funds, and any funds maintained under the charter or articles of incorporation of the company or association exclusively for the payment of claims arising under certificates of membership or policies issued upon the assessment plan and not subject to any other use. 236

SEC. 245. (a) That in the case of a life insurance company the term "net income" means the gross income less—

(1) The amount of interest received during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title; 235

(2) An amount equal to the excess, if any, over the deduction specified in paragraph (1) of this subdivision, of 4 per centum of the mean of the reserve funds required by law and held at the beginning and end of the taxable year, plus (in 236

Illustrated in Problem: case of life insurance companies issuing policies covering life, health, and accident insurance combined in one policy issued on the weekly premium payment plan, continuing for life and not subject to cancellation) 4 per centum of the mean of such reserve funds (not required by law) held at the beginning and end of the taxable year, as the Commissioner finds to be necessary for the protection of the holders of such policies only;

237 (3) The amount received as dividends (A) from a domestic corporation other than a corporation entitled to the benefits of section 262, or (B) from any foreign corporation when it is shown to the satisfaction of the Commissioner that more than 50 per centum of the gross income of such foreign corporation for the three-year period ending with the close of its taxable year preceding the declaration of such dividends (or for such part of such period as the foreign corporation has been in existence) was derived from sources within the United States as determined under section 217;

238 (4) An amount equal to 2 per centum of any sums held at the end of the taxable year as a reserve for dividends (other than dividends payable during the year following the taxable year) the payment of which is deferred for a period of not less than five years from the date of the policy contract;

239 (5) Investment expenses paid during the taxable year: *Provided,* That if any general expenses are in part assigned to or included in the investment expenses, the total deduction under this paragraph shall not exceed one-fourth of 1 per centum of the book value of the mean of the invested assets held at the beginning and end of the taxable year;

240 (6) Taxes and other expenses paid during the taxable year exclusively upon or with respect to the real estate owned by the company, not including taxes assessed against local benefits of a kind tending to increase the value of the property assessed, and not including any amount paid out for new buildings, or for permanent improvements or betterments made to increase the value of any property. The deduction allowed by this paragraph shall be allowed in the case of taxes imposed upon a shareholder or member of a company upon his interest as

shareholder or member, which are paid by the company without reimbursement from the shareholder or member, but in such cases no deduction shall be allowed the shareholder or member for the amount of such taxes; *Illustrated in Problem:*

(7) A reasonable allowance for the exhaustion, wear and tear of property, including a reasonable allowance for obsolescence. In the case of property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913; 241

(8) All interest paid or accrued within the taxable year on its indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title; 94

(9) In the case of a domestic life insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 243 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000. 241

(b) No deduction shall be made under paragraph (6) and (7) of subdivision (a) on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied. Such rental value shall be not less than a sum which in addition to any rents received from other tenants shall provide a net income (after deducting taxes, depreciation, and all other expenses at the rate of 4 per centum per annum of the book value at the end of the taxable year of the real estate so owned or occupied. 241 242

(c) In the case of a foreign life insurance company the amount of its net income for any taxable year from sources within the United States shall be the same proportion of its net income for the taxable year from sources within and without the United States, which the reserve funds required by law and held 243

Illustrated in Problem:

by it at the end of the taxable year upon business transacted within the United States is of the reserve funds held by it at the end of the taxable year upon all business transacted.

244 SEC. 246. (a) That, in lieu of the taxes imposed by sections 230 and 1000, there shall be levied, collected and paid for the calendar year 1922, and for each taxable year thereafter, upon the net income of every insurance company (other than a life or mutual insurance company) a tax as follows:

(1) In the case of such a domestic insurance company the same percentage of its net income as is imposed upon other corporations by section 230;

244 (2) In the case of such a foreign insurance company the same percentage of its net income from sources within the United States as is imposed upon the net income of other corporations by section 230.

(b) In the case of an insurance company subject to the tax imposed by this section—

(1) The term "gross income" means the combined gross amount, earned during the taxable year, from investment income and from underwriting income as provided in this subdivision, computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Convention of Insurance Commissioners;

(2) The term "net income" means the gross income as defined in paragraph (1) of this subdivision less the deductions allowed by section 247;

(3) The term "investment income" means the gross amount of income earned during the taxable year from interest, dividends and rents, computed as follows:

To all interest, dividends and rents received during the taxable year, add interest, dividends and rents due and accrued at the end of the taxable year, and deduct all interest, dividends and rents due and accrued at the end of the preceding taxable year;

(4) The term "underwriting income" means the premiums earned on insurance contracts during the taxable year less losses incurred and expenses incurred;

Illustrated in Problem:

(5) The term "premiums earned on insurance contracts during the taxable year" means an amount computed as follows:

From the amount of gross premiums written on insurance contracts during the taxable year, deduct return premiums and premiums paid for reinsurance. To the result so obtained add unearned premiums on outstanding business at the end of the preceding taxable year and deduct unearned premiums on outstanding business at the end of the taxable year;

(6) The term "losses incurred" means losses incurred during the taxable year on insurance contracts, computed as follows:

To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year, and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year. To the result so obtained add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year;

(7) The term "expenses incurred" means all expenses shown on the annual statement approved by the National Convention of Insurance Commissioners, and shall be computed as follows:

To all expenses paid during the taxable year add expenses unpaid at the end of the taxable year and deduct expenses unpaid at the end of the preceding taxable year. For the purpose of computing the net income subject to the tax imposed by this section there shall be deducted from expenses incurred as defined in this paragraph all expenses incurred which are not allowed as deductions by section 247.

Sec. 247. (a) That in computing the net income of an insurance company subject to the tax imposed by section 246 there shall be allowed as deductions:

(1) All ordinary and necessary expenses incurred, as pro- 94
vided in paragraph (1) of subdivision (a) of section 234;

(2) All interest as provided in paragraph (2) of subdivi- 96
sion (a) of section 234;

Illustrated in Problem:

(3) Taxes as provided in paragraph (3) of subdivision (a) of section 234;

(4) Losses incurred;

(5) Bad debts in the nature of agency balances and bills receivable ascertained to be worthless and charged off within the taxable year;

(6) The amount received as dividends from corporations as provided in paragraph (6) of subdivision (a) of section 234;

(7) The amount of interest earned during the taxable year which under paragraph (4) of subdivision (b) of section 213 is exempt from taxation under this title, and the amount of interest allowed as a credit under subdivision (a) of section 236;

(8) A reasonable allowance, for the exhaustion, wear and tear of property, as provided in paragraph (7) of subdivision (a) of section 234;

(9) In the case of such a domestic insurance company, the net income of which (computed without the benefit of this paragraph) is $25,000 or less, the sum of $2,000; but if the net income is more than $25,000 the tax imposed by section 246 shall not exceed the tax which would be payable if the $2,000 credit were allowed, plus the amount of the net income in excess of $25,000.

(b) In the case of a foreign corporation the deductions allowed in this section shall be allowed to the extent provided in subdivision (b) of section 234;

(c) Nothing in this section or in section 246 shall be construed to permit the same item to be twice deducted.

Part IV.—Administrative Provisions

PAYMENT OF TAXES

245 Sec. 250. (a) That except as otherwise provided in this section and sections 221 and 237 the tax shall be paid in four
199 installments, each consisting of one-fourth of the total amount of the tax. The first installment shall be paid at the time

fixed by law for filing the return, and the second installment *Illustrated in Problem:*
shall be paid on the fifteenth day of the third month, the third installment on the fifteenth day of the sixth month, and the fourth installment on the fifteenth day of the ninth month, after the time fixed by law for filing the return. Where an extension of time for filing a return is granted the time for payment of the first installment shall be postponed until the date of the expiration of the period of the extension, but the time for payment of the other installments shall not be postponed, unless the Commissioner so provides in granting the extension. In any case in which the time for the payment of any installment is at the request of the taxpayer thus postponed, there shall be added as a part of such installment interest thereon at the rate of one-half of 1 per centum per month from the time it would have been due if no extension
had been granted, until paid. If any installment is not paid 246
when due, the whole amount of the tax unpaid shall become due and payable upon notice and demand by the collector.

The tax may at the option of the taxpayer be paid in a
single payment instead of installments, in which case the total 245
amount shall be paid on or before the time fixed by law for 199
filing the return, or, where an extension of time for filing the return has been granted, on or before the expiration of the period of such extension.

(b) As soon as practicable after the return is filed, the 247
Commissioner shall examine it. If it then appears that the correct amount of the tax is greater or less than that shown in the return, the installments shall be recomputed. If the amount already paid exceeds that which should have been paid on the basis of the installments as recomputed, the excess so paid shall be credited against the subsequent installments; and if the amount already paid exceeds the correct amount of the tax, the excess shall be credited or refunded to the taxpayer in accordance with the provisions of section 252.

If the amount already paid is less than that which should 248
have been paid, the difference, to the extent not covered by any credits due to the taxpayer under section 252 (herein-

Illustrated in Problem:

after called "deficiency"), together with interest thereon at the rate of one-half of 1 per centum per month from the time the tax was due (or, if paid on the installment basis, on the deficiency of each installment from the time the installment was due), shall be paid upon notice and demand by the collector. If any part of the deficiency is due to negligence or in-
249 tentional disregard of authorized rules and regulations with knowledge thereof, but without intent to defraud, there shall be added as part of the tax 5 per centum of the total amount of the deficiency in the tax, and interest in such a case shall be collected at the rate of 1 per centum per month on the amount of such deficiency in the tax from the time it was due (or, if paid on the installment basis, on the amount of the deficiency in each installment from the time the installment was due), which penalty and interest shall become due and payable upon notice and demand by the collector. If any part
250 of the deficiency is due to fraud with intent to evade tax,
251 then, in lieu of the penalty provided by section 3176 of the Revised Statutes, as amended, for false or fraudulent returns willfully made, but in addition to other penalties provided by law for false or fraudulent returns, there shall be added as part of the tax 50 per centum of the total amount of the deficiency in the tax. In such case the whole amount of the tax unpaid, including the penalty so added, shall become due and payable upon notice and demand by the collector.

251 (c) If the return is made pursuant to section 3176 of the Revised Statutes as amended, the amount of tax determied to be due under such return shall be paid upon notice and demand by the collector.

252 (d) The amount of income, excess-profits, or war-profits taxes due under any return made under this Act for the taxable year 1921 or succeeding taxable years shall be determined and assessed by the Commissioner within four years after the return was filed, and the amount of any such taxes due under any return made under this Act for prior taxable years or under prior income, excess-profits, or war-profits tax Acts, or under section 38 of the Act entitled "An Act to provide

revenue, equalize duties, and encourage the industries of the United States, and for other purposes,'' approved August 5, 1909, shall be determined and assessed within five years after the return was filed, unless both the Commissioner and the taxpayer consent in writing to a later determination, assessment, and collection of the tax; and no suit or proceeding for the collection of any such taxes due under this Act or under prior income, excess-profits, or war-profits tax Acts, or of any taxes due under section 38 of such Act of August 5, 1909, shall be begun, after the expiration of five years after the date when such return was filed, but this shall not affect suits or proceedings begun at the time of the passage of this

Illustrated in Problem:

Act: *Provided,* That in the case of income received during 253
the lifetime of a decedent, all taxes due thereon shall be determined and assessed by the Commissioner within one year after written request therefor by the executor, administrator, or other fiduciary representing the estate of such decedent:
Provided further, That in the case of a false or fraudulent 254
return with intent to evade tax, or of a failure to file a required return, the amount of tax due may be determined, assessed, and collected, and a suit or proceeding for the collection of such amount may be begun, at any time after it becomes
due: *Provided further,* That in cases coming within the scope 255
of paragraph (9) of subdivision (a) of section 214, or of paragraph (8) of subdivision (a) of section 234, or in cases of final settlement of losses and other deductions tentatively allowed by the Commissioner pending a determination of the exact amount deductible, the amount of tax or deficiency in tax due may be determined, assessed, and collected at any time; but prior to the assessment thereof the taxpayer shall be notified and given a period of not less than thirty days in which to file an appeal and be heard as hereinafter provided in this subdivision.

If upon examination of a return made under the Revenue 256
Act of 1916, the Revenue Act of 1917, the Revenue Act of 1918, or this Act, a tax or a deficiency in tax is discovered, the taxpayer shall be notified thereof and given a period of

Illustrated in Problem:

not less than thirty days after such notice is sent by registered mail in which to file an appeal and show cause or reason why the tax or deficiency should not be paid. Opportunity for hearing shall be granted and a final decision thereon shall be made as quickly as practicable. Any tax or deficiency in tax then determined to be due shall be assessed and paid, together with the penalty and interest, if any, applicable thereto, within ten days after notice and demand by the collector as hereinafter provided, and in such cases no claim in abatement of the amount so assessed shall be entertained: *Provided*, That in cases where the Commissioner believes that the collection of the amount due will be jeopardized by such delay he may make the assessment without giving such notice or awaiting the conclusion of such hearing.

257 (e) If any tax remains unpaid after the date when it is due, and for ten days after notice and demand by the collector, then, except in the case of estates of insane, deceased, or insolvent persons, there shall be added as part of the tax the sum of 5 per centum on the amount due but unpaid, plus interest at the rate of 1 per centum per month upon such amount from the time it became due: *Provided*, That as to any such
258 amount which is the subject of a bona fide claim for abatement filed within ten days after notice and demand by the collector, where the taxpayer has not had the benefit of the provisions of subdivision (d), such sum of 5 per centum shall not be added and the interest from the time the amount was due until the claim is decided shall be at the rate of one-half of 1 per centum per month on that part of the claim rejected.

In the case of the first installment provided for in subdivision (a) the instructions printed on the return shall be sufficient notice of the date when the tax is due and sufficient demand, and the taxpayer's computation of the tax on the return shall be sufficient notice of the amount due. In the case of each subsequent installment the collector may, within thirty days and not later than ten days before the installment becomes due, mail to the taxpayer notice of the amount of the installment and the date on which it is due for payment. Such

notice of the collector shall be sufficient notice and sufficient de- *Illustrated in Problem:*
mand under this section.

(f) In the case of any deficiency (except where the defi-
ciency is due to negligence or fraud with intent to evade 259
tax) where it is shown to the satisfaction of the Commissioner
that the payment of such deficiency would result in undue hard-
ship to the taxpayer, the Commissioner may, with the approval
of the Secretary, extend the time for the payment of such
deficiency or any part thereof for such period not in excess
of eighteen months from the passage of this Act as the Com-
missioner may determine. In such case the Commissioner may
require the taxpayer to furnish a bond with sufficient sureties
conditioned upon the payment of the deficiency in accordance
with the terms of the extension granted. There shall be added
in lieu of other interest provided by law, as a part of such 259
deficiency, interest thereon at the rate of two-thirds of 1 per
centum per month from the time such extension is granted; 260
except where such other interest provided by law is in excess
of interest at the rate of two-thirds of 1 per centum per month. 261
If the deficiency or any part thereof is not paid in accordance
with the terms of the extension granted, there shall be added
as part of the deficiency, in lieu of other interest and penalties
provided by law, the sum of 5 per centum of the deficiency
and interest on the deficiency at the rate of 1 per centum per
month from the time it becomes payable in accordance with
the terms of such extension.

(g) If the Commissioner finds that a taxpayer designs
quickly to depart from the United States or to remove his prop- 262
erty therefrom, or to conceal himself or his property therein, or to do any other act tending to prejudice or to render wholly or partly ineffectual proceedings to collect the tax for the taxable year then last past or the taxable year then current unless such proceedings be brought without delay, the Commissioner shall declare the taxable period for such taxpayer immediately terminated and shall cause notice of such finding and declaration to be given the taxpayer, together with a demand for immediate payment of the tax for the taxable period so

Illustrated in Problem:

declared terminated and of the tax for the preceding taxable year or so much of said tax as is unpaid, whether or not the time otherwise allowed by law for filing return and paying the tax has expired; and such taxes shall thereupon become immediately due and payable. In any action or suit brought to enforce payment of taxes made due and payable by virtue of the provisions of this subdivision the finding of the Commissioner, made as herein provided, whether made after notice to the taxpayer or not, shall be for all purposes presumptive evidence of the taxpayer's design. A taxpayer who is not in default in making any return or paying income, war-profits, or excess-profits tax under any Act of Congress may furnish to the United States, under regulations to be prescribed by the Commissioner with the approval of the Secretary, security approved by the Commissioner that he will duly make the return next thereafter required to be filed and pay the tax next thereafter required to be paid. The Commissioner may approve and accept in like manner security for return and payment of taxes made due and payable by virtue of the provisions of this subdivision, provided the taxpayer has paid in full all other income, war-profits, or excess-profits taxes due from him under any Act of Congress. If security is approved and accepted pursuant to the provisions of this subdivision and such further or other security with respect to the tax or taxes covered thereby is given as the Commissioner shall from time to time find necessary and require, payment of such taxes shall not be enforced by any proceedings under the provisions of this subdivision prior to the expiration of the time otherwise allowed for paying such respective taxes. In the case of a citizen of the United
263 States about to depart from the United States the Commissioner may, at his discretion, waive any or all of the requirements placed on the taxpayer by this subdivision. No alien shall depart from the United States unless he first secures from the collector or agent in charge a certificate that he has complied with all the obligations imposed upon him by the income, war-profits, and excess-profits tax laws. If a taxpayer violates or attempts to violate this subdivision there shall, in addition

to all other penalties, be added as part of the tax 25 per centum of the total amount of the tax or deficiency in the tax, together with interest at the rate of 1 per centum per month from the time the tax became due. *Illustrated in Problem:*

(h) The provisions of subdivisions (e), (f) and (g) of this section shall apply to the assessment and collection of taxes 259
which have accrued or may accrue under the Revenue Act of 1917, the Revenue Act of 1918 or this Act.

RECEIPTS FOR TAXES

SEC. 251. That every collector to whom any payment of any 264
tax is made under the provisions of this title shall upon request give to the person making such payment a full written or printed receipt, stating the amount paid and the particular account for which such payment was made; and whenever any debtor pays taxes on account of payments made or to be made by him to separate creditors the collector shall, if requested by such debtor, give a separate receipt for the tax paid on account of each creditor in such form that the debtor can conveniently produce such receipts separately to his several creditors in satisfaction of their respective demands up to the amounts stated in the receipt; and such receipt shall be sufficient evidence in favor of such debtor to justify him in withholding from his next payment to his creditor the amount therein stated; but the creditor may, upon giving to his debtor a full written receipt acknowledging the payment to him of any sum actually paid and accepting the amount of tax paid as aforesaid (specifying the same) as a further satisfaction of the debt to that amount, require the surrender to him of such collector's receipt.

REFUNDS

SEC. 252. That if, upon examination of any return of income 265
made pursuant to this Act, the Act of August 5, 1909, entitled "An Act to provide revenue, equalize duties, and encourage the industries of the United States, and for other purposes," the Act of October 3, 1913, entitled "An Act to reduce tariff duties and to provide revenue for the Government, and for other pur-

Illustrated n Problem:

poses," the Revenue Act of 1916, as amended, the Revenue Act of 1917, or the Revenue Act of 1918, it appears that an amount of income, war-profits or excess-profits tax has been paid in excess of that properly due, then, notwithstanding the provisions of section 3228 of the Revised Statutes, the amount of the excess shall be credited against any income, war-profits or excess-profits taxes, or installment thereof, then due from the taxpayer under any other return, and any balance of such excess shall be immediately refunded to the taxpayer: *Provided,* That no such
267 credit or refund shall be allowed or made after five years from the date when the return was due, unless before the expiration
266 of such five years a claim therefor is filed by the taxpayer: *Provided further,* That if upon examination of any return of income made pursuant to the Revenue Act of 1917, the Revenue Act of 1918, or this Act, the invested capital of a taxpayer is decreased by the Commissioner, and such decrease is due to the fact that the taxpayer failed to take adequate deductions in previous years, with the result that an amount of income tax in excess of that properly due was paid in any previous year or years, then, notwithstanding any other provision of law and regardless of the expiration of such five-year period, the amount of such excess shall, without the filing of any claim therefor, be credited or refunded as provided in this section: *And provided further,* That nothing in this section shall be construed to bar from allowance claims for refund filed prior to the passage of the Revenue Act of 1918 under subdivision (a) of section 14 of the Revenue Act of 1916, or filed prior to the passage of this Act under section 252 of the Revenue Act of 1918.

PENALTIES

SEC. 253. That any individual, corporation, or partnership
268 required under this title to pay or collect any tax, to make a return or to supply information, who fails to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, shall be liable to a penalty of not more than $1,000. Any individual, cor-

poration, or partnership, or any officer or employee of any corporation or member or employee of a partnership, who willfully refuses to pay or collect such tax, to make such return, or to supply such information at the time or times required under this title, or who willfully attempts in any manner to defeat or evade the tax imposed by this title, shall be guilty of a misdemeanor and shall be fined not more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution. *Illustrated in Problem:*

RETURNS OF PAYMENTS OF DIVIDENDS

SEC. 254. That every corporation subject to the tax imposed by this title and every personal service corporation shall, when required by the Commissioner, render a correct return, duly verified under oath, of its payments of dividends, stating the name and address of each stockholder, the number of shares owned by him, and the amount of dividends paid to him. 269

RETURNS OF BROKERS

SEC. 255. That every individual, corporation, or partnership doing business as a broker shall, when required by the Commissioner, render a correct return duly verified under oath, under such rules and regulations as the Commissioner, with the approval of the Secretary, may prescribe, showing the names of customers for whom such individual, corporation, or partnership has transacted any business, with such details as to the profits, losses, or other information which the Commissioner may require, as to each of such customers, as will enable the Commissioner to determine whether all income tax due on profits or gains of such customers has been paid. 270

INFORMATION AT SOURCE

SEC. 256. That all individuals, corporations, and partnerships, in whatever capacity acting, including lessees or mortgagors of real or personal property, fiduciaries, and employers, making payment to another individual, corporation, or partner- 271

Illustrated in Problem: ship, of interest, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income (other than payments described in sections 254 and 255), of $1000 or more in any taxable year, or, in the case of such payments made by the United States, the officers or employees of the United States having information as to such payments and required to make returns in regard thereto by the regulations hereinafter provided for, shall render a true and accurate return to the Commissioner, under such regulations and in such form and manner and to such extent as may be prescribed by him with the approval of the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

272 Such returns may be required, regardless of amounts, (1) in the case of payments of interest upon bonds, mortgages, deeds of trust, or other similar obligations of corporations, and (2) in the case of collections of items (not payable in the United States) of interest upon the bonds of foreign countries and interest upon the bonds of and dividends from foreign corporations by individuals, corporations, or partnerships, undertaking as a matter of business or for profit the collection of foreign payments of such interest or dividends by means of coupons, checks, or bills of exchange.

When necessary to make effective the provisions of this section the name and address of the recipient of income shall be furnished upon demand of the individual, corporation, or partnership paying the income.

The provisions of this section shall apply to the calendar year 1921 and each calendar year thereafter, but shall not apply to the payment of interest on obligations of the United States.

RETURNS TO BE PUBLIC RECORDS

273 SEC. 257. That returns upon which the tax has been determined by the Commissioner shall constitute public records; but they shall be open to inspection only upon order of the President and under rules and regulations prescribed by the

Secretary and approved by the President: *Provided,* That the proper officers of any State imposing an income tax may, upon the request of the governor thereof, have access to the returns of any corporation, or to an abstract thereof showing the name and income of the corporation, at such times and in such manner as the Secretary may prescribe: *Provided further,* That all bona fide stockholders of record, owning 1 per centum or more of the outstanding stock of any corporation shall, upon making request of the Commissioner, be allowed to examine the annual income returns of such corporation and of its subsidiaries. Any stockholder who pursuant to the provisions of this section is allowed to examine the return of any corporation, and who makes known in any manner whatever not provided by law the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any such return, shall be guilty of a misdemeanor and be punished by a fine not exceeding $1,000, or by imprisonment not exceeding one year, or both. *Illustrated in Problem:*

The Commissioner shall as soon as practicable in each year cause to be prepared and made available to public inspection in such manner as he may determine, in the office of the collector in each internal revenue district and in such other places as he may determine, lists containing the names and the post-office addresses of all individuals making income-tax returns in such district.

PUBLICATION OF STATISTICS

SEC. 258. That the Commissioner, with the approval of the Secretary, shall prepare and publish annually statistics reasonably available with respect to the operation of the income, war-profits and excess-profits tax laws, including classifications of taxpayers and of income, the amounts allowed as deductions, exemptions, and credits, and any other facts deemed pertinent and valuable. 274

COLLECTION OF FOREIGN ITEMS.

SEC. 259. That all individuals, corporations, or partnerships

Illustrated in Problem:

undertaking as a matter of business or for profit the collection of foreign payments of interest or dividends by means of cou-
275 pons, checks, or bills of exchange shall obtain a license from the Commissioner and shall be subject to such regulations enabling the government to obtain the information required under this title as the Commissioner, with the approval of the Secretary, shall prescribe; and whoever knowingly undertakes to collect such payments without having obtained a license therefor, or without complying with such regulations, shall be guilty of a misdemeanor and shall be fined not more than $5,000, or imprisoned for not more than one year, or both.

CITIZENS OF POSSESSIONS OF THE UNITED STATES

276 Sec. 260. That any individual who is a citizen of any possession of the United States (but not otherwise a citizen of the United States) and who is not a resident of the United States, shall be subject to taxation under this title only as to income derived from sources within the United States, and in such case the tax shall be computed and paid in the same manner and subject to the same conditions as in the case of other persons who are taxable only as to income derived from such sources.

Nothing in this section shall be construed to alter or amend the provisions of the Act entitled "An Act making appropriations for the naval service for the fiscal year ending June 30, 1922, and for other purposes," approved July 12, 1921, relating to the imposition of income taxes in the Virgin Islands of the United States.

PORTO RICO AND PHILIPPINE ISLANDS

277 Sec. 261. That in Porto Rico and the Philippine Islands the income tax shall be levied, assessed, collected, and paid as provided by law prior to the passage of this Act.

The Porto Rican or Philippine Legislature shall have power by due enactment to amend, alter, modify, or repeal the income tax laws in force in Porto Rico or the Philippine Islands, respectively.

INCOME FROM SOURCES WITHIN THE POSSESSIONS OF THE UNITED STATES

SEC. 262. (a) That in the case of citizens of the United States or domestic corporations, satisfying the following conditions, gross income means only gross income from sources within the United States— *Illustrated in Problem:* 278

(1) If 80 per centum or more of the gross income of such citizen or domestic corporation (computed without the benefit of this section) for the three-year period immediately preceding the close of the taxable year (or for such part of such period immediately preceding the close of such taxable year as may be applicable) was derived from sources within a possession of the United States; and

(2) If, in the case of such corporation, 50 per centum or more of its gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States; or

(3) If, in the case of such citizen, 50 per centum or more of his gross income (computed without the benefit of this section) for such period or such part thereof was derived from the active conduct of a trade or business within a possession of the United States either on his own account or as an employee or agent of another. 278

(b) Notwithstanding the provisions of subdivision (a) there shall be included in gross income all amounts received by such citizens or corporations within the United States, whether derived from sources within or without the United States.

(c) As used in this section the term "possession of the United States" does not include the Virgin Islands of the United States.

EFFECTIVE DATE OF TITLE

SEC. 263. That this title shall take effect as of January 1, 1921.

TITLE III.—WAR-PROFITS AND EXCESS-PROFITS TAX FOR 1921

Illustrated in Problem:

PART I.—GENERAL DEFINITIONS

SEC. 300. That when used in this title the terms "taxable year," "fiscal year," "personal service corporation," "paid or accrued," and "dividends" shall have the same meaning as provided for the purposes of income tax in sections 200 and 201.

PART II.—IMPOSITION OF TAX

44 SEC. 301. (a) That in lieu of the tax imposed by Title III of the Revenue Act of 1918, but in addition to the other taxes imposed by this Act, there shall be levied, collected and paid for the calendar year 1921 upon the net income of every corporation (except corporations taxable under subdivision (b) of this section) a tax equal to the sum of the following:

FIRST BRACKET

20 per centum of the amount of the net income in excess of the excess-profits credit (determined under section 312) and not in excess of 20 per centum of the invested capital;

SECOND BRACKET

40 per centum of the amount of the net income in excess of 20 per centum of the invested capital.

(b) For the calendar year 1921 there shall be levied, col-
279 lected, and paid upon the net income of every corporation which derives in such year a net income of more than $10,000 from any Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive, a tax equal to the sum of the following:

(1) Such a portion of a tax computed at the rates specified in subdivision (a) of section 301 of the Revenue Act of 1918, as the part of the net income attributable to such Government contract or contracts, bears to the entire net income. In com-

puting such tax the excess-profits credit and the war-profits credit which would be applicable to such calendar year under the Revenue Act of 1918 if it had been continued in force, shall be used; *Illustrated in Problem:*

(2) Such a portion of a tax computed at the rates specified in subdivision (a) of this section as the part of the net income not attributable to such Government contract or contracts bears to the entire net income.

For the purpose of determining the part of the net income attributable to such Government contract or contracts, the proper apportionment and allocation of the deductions with respect to gross income derived from such Government contract or contracts and from other sources, respectively, shall be determined under rules and regulations prescribed by the Commissioner with the approval of the Secretary.

(c) In any case where the full amount of the excess-profits credit is not allowed under the first bracket of sub-division (a), by reason of the fact that such credit is in excess of 20 per centum of the invested capital, the part not so allowed shall be deducted from the amount in the second bracket. **280**

SEC. 302. That the tax imposed by subdivision (a) of section 301 shall in no case be more than 20 per centum of the amount of the net income in excess of \$3,000 and not in excess of \$20,000, plus 40 per centum of the amount of the net income in excess of \$20,000; and the limitations imposed by section 302 of the Revenue Act of 1918 (upon taxes computed under subdivision (c) of section 301 of that Act) are hereby made applicable to taxes computed under this subdivision (b) of section 301 of this Act. Nothing in this section shall be construed in such manner as to increase the tax imposed by section 301 of this Act. **281** **282**

SEC. 303. That if part of the net income of a corporation is derived (1) from a trade or business (or a branch of a trade or business) in which the employment of capital is necessary, and (2) a part (constituting not less than 30 per centum of its total net income) is derived from a separate trade or business (or a distinctly separate branch of the trade or business) **283**

Illustrated in Problem:

which if constituting the sole trade or business would bring it within the class of "personal service corporations," then (under regulations prescribed by the Commissioner with the approval of the Secretary) the tax upon the first part of such net income shall be separately computed (allowing in such computation only the same proportionate part of the credits authorized in section 312), and the tax upon the second part shall be the same percentage thereof as the tax so computed upon the first part is of such first part: *Provided,* That the tax upon such second part shall in no case be less than 20 per centum thereof, unless the tax upon the entire net income, if computed without benefit of this section, would constitute less than 20 per centum of such entire net income, in which event the tax shall be determined upon the entire net income, without reference to this section, as other taxes are determined under this title. The total tax computed under this section shall be subject to the limitations provided in section 302.

SEC. 304. (a) That the corporations enumerated in section 231 shall, to the extent that they are exempt from income tax under Title II, be exempt from taxation under this title.

(b) Any corporation whose net income for the taxable year is less than $3,000 shall be exempt from taxation under this title.

284 (c) In the case of any corporation engaged in the mining of gold, the portion of the net income derived from the mining of gold shall be exempt from the tax imposed by this title or any tax imposed by Title II of the Revenue Act of 1917, and the tax on the remaining portion of the net income shall be the same proportion of a tax computed without the benefit of this subdivision which such remaining portion of the net income bears to the entire net income.

323 SEC. 305. That if a tax is computed under this title for a period of less than twelve months, the specific exemption of $3,000, wherever referred to in this title, shall be reduced to an amount which is the same proportion of $3,000 as the number of months in the period is of twelve months.

PART III.—EXCESS-PROFITS CREDIT

SEC. 312. That the excess-profits credit shall consist of a *Illustrated in Problem:*
specific exemption of $3,000 plus an amount equal to 8 per 285
centum of the invested capital for the taxable year. 286

A foreign corporation or a corporation entitled to the benefits of section 262 shall not be entitled to the specific exemption of $3,000.

PART IV.—NET INCOME

SEC. 320. That for the purpose of this title the net income of a corporation shall be ascertained and returned for the taxable year upon the same basis and in the same manner as provided for income tax purposes in Title II of this Act.

PART V.—INVESTED CAPITAL

SEC. 325. (a) That as used in this title—

The term "intangible property" means patents, copyrights, 289
secret processes and formulae, good will, trade-marks, trade-brands, franchises, and other like property;

The term "tangible property" means stocks, bonds, notes, 304
and other evidences of indebtedness, bills and accounts receivable, lease-holds, and other property other than intangible property;

The term "borrowed capital" means money or other property
borrowed, whether represented by bonds, notes, open accounts, 302
or otherwise;

The term "inadmissible assets" means stocks, bonds, and
other obligations (other than obligations of the United States), 287
the dividends or interest from which is not included in com- 288
puting net income, but where the income derived from such
assets consists in part of gain or profit derived from the sale 290
or other disposition thereof, or where all or part of the interest
derived from such assets is in effect included in the net income
because of the limitation on the deduction of interest under 291
paragraph (2) of subdivision (a) of section 234, a corresponding part of the capital invested in such assets shall not be deemed to be inadmissible assets;

Illustrated in Problem:

The term "admissible assets" means all assets other than
293 inadmissible assets, valued in accordance with the provisions of
subdivision (a) of section 326 and section 331.

294 (b) For the purposes of this title the par value of stock or shares shall, in the case of stock or shares issued at a nominal value or having no par value, be deemed to be the fair market value as of the date or dates of issue of such stock or shares.

SEC. 326 (a) That as used in this title the term "invested capital" for any year means (except as provided in subdivision (b) and (c) of this section):

295, 310 (1) Actual cash bona fide paid in for stock or shares;

296, 311 (2) Actual cash value of tangible property, other than cash,
297, 312 bona fide paid in for stock or shares, at the time of such payment, but in no case to exceed the par value of the original
298, 313 stock or shares specifically issued therefor, unless the actual
299, 314 cash value of such tangible property at the time paid in is shown to the satisfaction of the Commissioner to have been
300 clearly and substantially in excess of such par value, in which case such excess shall be treated as paid-in surplus: *Provided,* That the Commissioner shall keep a record of all cases in which tangible property is included in invested capital at a value in excess of the stock or shares issued therefor, containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, the value of the tangible property at the time paid in, the par value of the stock or shares specifically issued therefor and the amount included under this paragraph as paid-in surplus. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257;

295, 303, 315 (3) Paid-in or earned surplus and undivided profits; not in-
317, 319, 321 cluding surplus and undivided profits earned during the year;

297, 305, 316 (4) Intangible property bona fide paid in for stock or shares
318, 324 prior to March 3, 1917, in an amount not exceeding (a) the
306, 308 actual cash value of such property at the time paid in, (b) the
307, 314 par value of the stock or shares issued therefor, or (c) in

the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding on March 3, 1917, whichever is lowest; *Illustrated in Problem:*

(5) Intangible property bona fide paid in for stock or shares on or after March 3, 1917, in an amount not exceeding (a) the actual cash value of such property at the time paid in, (b) the par value of the stock or shares issued therefor, or (c) in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year, whichever is lowest: *Provided,* That in no case shall the total amount included under paragraphs (4) and (5) exceed in the aggregate 25 per centum of the par value of the total stock or shares of the corporation outstanding at the beginning of the taxable year; but **307, 309** **308, 314**

(b) As used in this title the term "invested capital" does not include borrowed capital. **301** **302**

(c) There shall be deducted from invested capital as above defined a percentage thereof equal to the percentage which the amount of inadmissible assets is of the amount of admissible and inadmissible assets held during the taxable year. **287**

(d) The invested capital for any period shall be the average invested capital for such period, but in the case of a corporation making a return for a fractional part of a year, it shall be the same fractional part of such average invested capital. **322** **323**

SEC. 327. That in the following cases the tax shall be determined as provided in section 328:

(a) Where the Commissioner is unable to determine the invested capital as provided in section 326; **325**

(b) In the case of a foreign corporation or of a corporation entitled to the benefits of section 262; **326**

(c) Where a mixed aggregate of tangible property and intangible property has been paid in for stock or for stock and bonds and the Commissioner is unable satisfactorily to determine the respective values of the several classes of property at the time of payment, or to distinguish the classes of property paid in for stock and for bonds, respectively; **327**

Illustrated in Problem:

(d) Where upon application by the corporation the Commissioner finds and so declares of record that the tax if determined
328 without benefit of this section would, owing to abnormal conditions affecting the capital or income of the corporation, work upon the corporation an exceptional hardship evidenced by gross disproportion between the tax computed without benefit of this section and the tax computed by reference to the representative corporations specified in section 328. This subdivision shall not apply to any case (1) in which the tax (computed without benefit of this section) is high merely because the corporation earned within the taxable year a high rate of profit upon a normal invested capital, nor (2) in which 50 per
329 centum or more of the gross income of the corporation for the taxable year (computed under section 233 of Title II) consists of gains, profits, commissions, or other income, derived on a cost-plus basis from a Government contract or contracts made between April 6, 1917, and November 11, 1918, both dates inclusive.

SEC. 328. (a) That in the cases specified in section 327 the
330 tax shall be the amount which bears the same ratio to the net income of the taxpayer (in excess of the specific exemption of $3,000) for the taxable year, as the average tax of representative corporations engaged in a like or similar trade or business, bears to their average net income (in excess of the specific exemption of $3,000) for such year. In the case of a foreign corporation or of a corporation entitled to the benefits of section 262 the tax shall be computed without deducting the specific exemption of $3,000 either for the taxpayer or the representative corporations.

In computing the tax under this section the Commissioner shall compare the taxpayer only with representative corporations whose invested capital can be satisfactorily determined under section 326 and which are, as nearly as may be, similarly circumstanced with respect to gross income, net income, profits per unit of business transacted and capital employed, the amount and rate of war profits or excess profits, and all other relevant facts and circumstances.

(b) For the purposes of subdivision (a) the ratios between the average tax and the average net income of representative corporations shall be determined by the Commissioner in accordance with regulations prescribed by him with the approval of the Secretary. *Illustrated in Problem:*

(c) The Commissioner shall keep a record of all cases in which the tax is determined in the manner prescribed in subdivision (a), containing the name and address of each taxpayer, the business in which engaged, the amount of invested capital and net income shown by the return, and the amount of invested capital as determined under such subdivision. The Commissioner shall furnish a copy of such record and other detailed information with respect to such cases when required by resolution of either House of Congress, without regard to the restrictions contained in section 257.

Part VI.—Reorganizations

Sec. 331. That in the case of the reorganization, consolida-
tion, or change of ownership of a trade or business, or change 331
of ownership of property, after March 3, 1917, if an interest 332
or control in such trade or business or property of 50 per
centum or more remains in the same persons, or any of them, 333
then no asset transferred or received from the previous owner shall, for the purpose of determining invested capital, be allowed a greater value than would have been allowed under this title in computing the invested capital of such previous owner if such asset had not been so transferred, or received: *Provided,* That if such previous owner was not a corporation, then the value of any asset so transferred or received shall be taken at its cost of acquisition (at the date when acquired by such previous owner) with proper allowance for depreciation, impairment, betterment or development, but no addition to the original cost shall be made for any charge or expenditure deducted as expense or otherwise on or after March 1, 1913, in computing the net income of such previous owner for purposes of taxation.

Part VII.—Miscellaneous

Illustrated in Problem:

Sec. 335. (a) That if a corporation (other than a personal service corporation) makes return for a fiscal year beginning
334 in 1920 and ending in 1921, the war-profits and excess-profits tax for the taxable year 1921 shall be the sum of: (1) the same proportion of a tax for the entire period computed under the Revenue Act of 1918, which the portion of such period falling within the calendar year 1920 is of the entire period, and (2) the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period. Any amount heretofore or hereafter paid on account of the tax imposed for such taxable year by the Revenue Act of 1918 shall be credited towards the payment of the tax as above computed, and if the amount so paid exceeds the amount of such tax, the excess shall be credited or refunded to the corporation in accordance with the provisions of section 252 of this Act.

(b) If a corporation (other than a personal service corpora-
335 tion) makes a return for a fiscal year beginning in 1921 and ending in 1922, the war-profits and excess-profits tax for the portion of the year falling within the calendar year 1921 shall be an amount equivalent to the same proportion of a tax for the entire period computed under this title, which the portion of such period falling within the calendar year 1921 is of the entire period.

Sec. 336. That every corporation, not exempt under section 304, shall make a return for the purposes of this title. Such returns shall be made, and the taxes imposed by this title shall be paid, at the same times and places, in the same manner, and subject to the same conditions, as is provided in the case of returns and payment of income tax by corporations for the purposes of Title II, and all the provisions of that title not inapplicable, including penalties, are hereby made applicable to the taxes imposed by this title.

Sec. 337. That in the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value

Illustrated in Problem:

of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by this title attributable to such sale 336
shall not exceed 20 per centum of the selling price of such property or interest.

EFFECTIVE DATE OF TITLE

Sec. 338. That this title shall take effect as of January 1, 1921.

TITLE XIII.—GENERAL ADMINISTRATIVE PROVISIONS

LAWS MADE APPLICABLE

Sec. 1300. That all administrative, special, or stamp provisions of law, including the law relating to the assessment of taxes, so far as applicable, are hereby extended to and made a part of this Act, and every person liable to any tax imposed by this Act, or for the collection thereof, shall keep such records and render, under oath, such statements and returns, and shall comply with such regulations as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

METHOD OF COLLECTING TAX

Sec. 1301. . . . All administrative and penalty provisions of Title XI, in so far as applicable, shall apply to the collection of any tax which the Commissioner determines or prescribes shall be collected in such manner.

PENALTIES

Sec. 1302. . . . (b) Any person who willfully refuses to pay,
collect, or truly account for and pay over any such tax, make such 250
return or supply such information at the time or times required by law or regulation, or who willfully attempts in any manner to evade such tax, shall be guilty of a misdemeanor and in addition to other penalties provided by law shall be fined not

more than $10,000 or imprisoned for not more than one year, or both, together with the costs of prosecution. . . .

RULES AND REGULATIONS

Sec. 1303. That the Commissioner, with the approval of the Secretary, is hereby authorized to make all needful rules and regulations for the enforcement of the provisions of this Act. . . .

FRACTIONAL PARTS OF A CENT

Sec. 1306. That in the payment of any tax under this Act not payable by stamp a fractional part of a cent shall be disregarded unless it amounts to one-half cent or more, in which case it shall be increased to 1 cent.

RETURNS

Sec. 1307. That whenever in the judgment of the Commissioner necessary he may require any person, by notice served upon him, to make a return or such statements as he deems sufficient to show whether or not such person is liable to tax.

EXAMINATION OF BOOKS AND WITNESSES

Sec. 1308. That the Commissioner, for the purpose of ascertaining the correctness of any return or for the purpose of making a return where none has been made, is hereby authorized, by any revenue agent or inspector designated by him for that purpose, to examine any books, papers, records, or memoranda bearing upon the matters required to be included in the return, and may require the attendance of the person rendering the return or of any officer or employee of such person, or the attendance of any other person having knowledge in the premises, and may take his testimony with reference to the matter required by law to be included in such return, with power to administer oaths to such person or persons.

UNNECESSARY EXAMINATIONS

Sec. 1309. That no taxpayer shall be subjected to unneces-

sary examinations or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Commissioner, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

JURISDICTION OF COURTS

Sec. 1310. (a) That if any person is summoned under this Act to appear, to testify, or to produce books, papers or other data, the district court of the United States for the district in which such person resides shall have jurisdiction by appropriate process to compel such attendance, testimony, or production of books, papers, or other data.

(b) The district courts of the United States at the instance of the United States are hereby invested with such jurisdiction to make and issue, both in actions at law and suits in equity, writs and orders of injunction, and of ne exeat republica, orders appointing receivers, and such other orders and processes, and to render such judgments and decrees, granting in proper cases both legal and equitable relief together, as may be necessary or appropriate for the enforcement of the provisions of this Act. The remedies hereby provided are in addition to and not exclusive of any and all other remedies of the United States in such courts or otherwise to enforce such provisions.

(c) Paragraph Twentieth of section 24 of the Judicial Code is amended by adding at the end thereof the following new pargraph:

"Concurrent with the Court of Claims, of any suit or proceeding, commenced after the passage of the Revenue Act of 1921, for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority or any sum alleged to have been excessive or in any manner wrongfully collected, under the internal-revenue laws, even if the claim exceeds $10,000, if the collector of internal-revenue by whom such tax, penalty, or sum was collected is dead at the time such suit or proceeding is commenced."

AMENDMENTS TO REVISED STATUTES

Sec. 1311. That sections 3164, 3165, 3167, 3172, 3173, and 3176 of the Revised Statutes, as amended, are reenacted, without change, as follows:

"Sec. 3164. It shall be the duty of every collector of internal revenue having knowledge of any willful violation of any law of the United States relating to the revenue, within thirty days after coming into possession of such knowledge, to file with the district attorney of the district in which any fine, penalty, or forfeiture may be incurred, a statement of all the facts and circumstances of the case within his knowledge, together with the names of the witnesses, setting forth the provisions of law believed to be so violated on which reliance may be had for condemnation or conviction.

"Sec. 3165. Every collector, deputy collector, internal-revenue agent, and internal-revenue officer assigned to duty under an internal-revenue agent, is authorized to administer oaths and to take evidence touching any part of the administration of the internal-revenue laws with which he is charged, or where such oaths and evidence are authorized by law or regulation authorized by law to be taken.

"Sec. 3167. It shall be unlawful for any collector, deputy collector, agent, clerk, or other officer or employee of the United States to divulge or to make known in any manner whatever not provided by law to any person the operations, style of work, or apparatus of any manufacturer or producer visited by him in the discharge of his official duties, or the amount or source of income, profits, losses, expenditures, or any particular thereof, set forth or disclosed in any income return, or to permit any income return or copy thereof or any book containing any abstract or particulars thereof to be seen or examined by any person except as provided by law; and it shall be unlawful for any person to print or publish in any manner whatever not provided by law any income return, or any part thereof or source of income, profits, losses or expenditures appearing in any income return; and any offense against the foregoing pro-

vision shall be a misdemeanor and be punished by a fine not exceeding $1,000 or by imprisonment not exceeding one year, or both, at the discretion of the court; and if the offender be an officer or employee of the United States, he shall be dismissed from office or discharged from employment.

"SEC. 3172. Every collector shall, from time to time, cause his deputies to proceed through every part of his district and inquire after and concerning all persons therein who are liable to pay any internal-revenue tax, and all persons owning or having the care and management of any objects liable to pay any tax, and to make a list of such persons and enumerate said objects.

"SEC. 3173. It shall be the duty of any person, partnership, firm, association, or corporation, made liable to any duty, special tax, or other tax imposed by law, when not otherwise provided for, (1) in case of a special tax, on or before the thirty-first day of July in each year, and (2) in other cases before the day on which the taxes accrue, to make a list or return, verified by oath, to the collector or a deputy collector of the district where located, of the articles or objects, including the quantity of goods, wares, and merchandise, made or sold and charged with a tax, the several rates and aggregate amount, according to the forms and regulations to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, for which such person, partnership, firm, association, or corporation is liable: *Provided*, That if any person liable to pay any duty or tax, or owning, possessing, or having the care or management of property, goods, wares, and merchandise, article or objects liable to pay any duty, tax, or license, shall fail to make and exhibit a list or return required by law, but shall consent to disclose the particulars of any and all the property, goods, wares, and merchandise, articles, and objects liable to pay any duty or tax, or any business or occupation liable to pay any tax as aforesaid, then, and in that case, it shall be the duty of the collector or deputy collector to make such list or return, which, being distinctly read, consented to, and signed and verified by oath by the person so own-

ing, possessing, or having the care and management as aforesaid, may be received as the list of such person: *Provided further,* That in case no annual list or return has been rendered by such person to the collector or deputy collector as required by law, and the person shall be absent from his or her residence or place of business at the time the collector or a deputy collector shall call for the annual list or return, it shall be the duty of such collector or deputy collector to leave at such place of residence or business, with some one of suitable age and discretion, if such be present, otherwise to deposit in the nearest post office, a note or memorandum addressed to such person, requiring him or her to render to such collector or deputy collector the list or return required by law within ten days from the date of such note or memorandum, verified by oath. And if any person, on being notified or required as aforesaid, shall refuse or neglect to render such list or return within the time required as aforesaid, or whenever any person who is required to deliver a monthly or other return of objects subject to tax fails to do so at the time required, or delivers any return which, in the opinion of the collector, is erroneous, false, or fraudulent, or contains any undervaluation or understatement, or refuses to allow any regularly authorized Government officer to examine the books of such person, firm, or corporation, it shall be lawful for the collector to summon such person, or any other person having possession, custody, or care of books of account containing entries relating to the business of such person or any other person he may deem proper, to appear before him and produce such books at a time and place named in the summons, and to give testimony or answer interrogatories, under oath, respecting any objects or income liable to tax or the returns thereof. The collector may summon any person residing or found within the State or Territory in which his district lies; and when the person intended to be summoned does not reside and can not be found within such State or Territory, he may enter any collection district where such person may be found and there make the examination herein authorized. And to this end he may there exercise all

the authority which he might lawfully exercise in the district for which he was commissioned: *Provided,* That 'person', as used in this section, shall be construed to include any corporation, joint-stock company or association, or insurance company when such construction is necessary to carry out its provisions.

Illustrated in Problem:

"SEC. 3176. If any person, corporation, company, or association fails to make and file a return or list at the time prescribed by law or by regulation made under authority of law, or makes, willfully or otherwise, a false or fraudulent return or list, the collector or deputy collector shall make the return or list from his own knowledge and from such information as he can obtain through testimony or otherwise. In any such case the Commissioner may, from his own knowledge and from such information as he can obtain through testimony or otherwise, make a return or amend any return made by a collector or deputy collector. Any return or list so made and subscribed by the Commissioner, or by a collector or deputy collector and approved by the Commissioner, shall be prima facie good and sufficient for all legal purposes. 251

"If the failure to file a return or list is due to sickness or absence the collector may allow such further time, not exceeding thirty days, for making and filing the return or list as he deems proper.

"The Commissioner of Internal Revenue shall determine and assess all taxes, other than stamp taxes, as to which returns or lists are so made under the provisions of this section. In case of any failure to make and file a return or list within the time prescribed by law, or prescribed by the Commissioner of Internal Revenue or the collector in pursuance of law, the Commissioner of Internal Revenue shall add to the tax 25 per centum of its amount, except that when a return is filed after such time and it is shown that the failure to file it was due to a reasonable cause and not to willful neglect, no such addition shall be made to the tax. In case a false or fraudulent return or list is willfully made, the Commissioner of Internal Revenue shall add to the tax 50 per centum of its amount.

"The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax."

FINAL DETERMINATION AND ASSESSMENTS

SEC. 1312. That if after a determination and assessment in any case the taxpayer has without protest paid in whole any tax or penalty, or accepted any abatement, credit, or refund based on such determination and assessment, and an agreement is made in writing between the taxpayer and the Commissioner, with the approval of the Secretary, that such determination and assessment shall be final and conclusive, then (except upon a showing of fraud or malfeasance or misrepresentation of fact materially affecting the determination or assessment thus made) (1) the case shall not be reopened or the determination and assessment modified by any officer, employee, or agent of the United States, and (2) no suit, action, or proceeding to annul, modify, or set aside such determination or assessment shall be entertained by any court of the United States.

ADMINISTRATIVE REVIEW

SEC. 1313. That in the absence of fraud or mistake in mathematical calculation, the findings of facts in and the decision of the Commissioner upon (or in case the Secretary is authorized to approve the same, then, after such approval) the merits of any claim presented under or authorized by the internal-revenue laws shall not be subject to review by any other administrative officer, employee, or agent of the United States.

RETROACTIVE REGULATIONS

SEC. 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately oc-

casioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

REFUNDS

SEC. 1315. That section 3220 of the Revised Statutes, as amended, is reenacted without change, as follows:

"SEC. 3220. The Commissioner of Internal Revenue, subject to regulations prescribed by the Secretary of the Treasury, is authorized to remit, refund, and pay back all taxes erroneously or illegally assessed or collected, all penalties collected without authority, and all taxes that appear to be unjustly assessed or excessive in amount, or in any manner wrongfully collected; also to repay to any collector or deputy collector the full amount of such sums of money as may be recovered against him in any court, for any internal revenue taxes collected by him, with the cost and expenses of suit; also all damages and costs recovered against any assessor, assistant assessor, collector, deputy collector, agent, or inspector, in any suit brought against him by reason of anything done in the due performance of his official duty, and shall make report to Congress at the beginning of each regular session of Congress of all transactions under this section."

SEC. 1316. That section 3228 of the Revised Statutes is amended to read as follows:

"SEC. 3228. All claims for the refunding or crediting of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty alleged to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, must be presented to the Commissioner of Internal Revenue within four years next after payment of such tax, penalty, or sum."

This section, except as modified by section 252, shall apply retroactively to claims for refund under the Revenue Act of 1916, the Revenue Act of 1917, and the Revenue Act of 1918.

SEC. 1317. That the paragraph of section 3689 of the Re-

vised Statutes, as amended, reading as follows: "Refunding taxes illegally collected (internal revenue): To refund and pay back duties erroneously or illegally assessed or collected under the internal revenue laws," is repealed from and after June 30, 1920; and the Secretary of the Treasury shall submit for the fiscal year 1921, and annually thereafter, an estimate of appropriations to refund and pay back duties or taxes erroneously or illegally assessed or collected under the internal-revenue laws, and to pay judgments, including interest and costs, rendered for taxes or penalties erroneously or illegally assessed or collected under the internal-revenue laws.

LIMITATIONS UPON SUITS AND PROSECUTIONS

SEC. 1318. That section 3226 of the Revised Statutes is amended to read as follows:

"SEC. 3226. No suit or proceeding shall be maintained in any court for the recovery of any internal-revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Commissioner of Internal Revenue, according to the provisions of law in that regard, and the regulations of the Secretary of the Treasury established in pursuance thereof. No such suit or proceeding shall be begun before the expiration of six months from the date of filing such claim unless the Commissioner renders a decision thereon within that time, nor after the expiration of five years from the date of the payment of such tax, penalty, or sum."

This section shall not affect any suit or proceeding instituted prior to the passage of this Act, but shall apply to all suits and proceedings instituted after the passage of this Act, whether or not barred by prior Acts of Congress.

SEC. 1319. That section 3227 of the Revised Statutes is hereby repealed but such repeal shall not affect any suit or proceeding instituted prior to the passage of this Act.

SEC. 1320. That no suit or proceeding for collection of

any internal revenue tax shall be begun after the expiration of five years from the time such tax was due, except in the case of fraud with intent to evade tax, or willful attempt in any manner to defeat or evade tax. This section shall not apply to suits or proceedings for the collection of taxes under section 250 of this Act, nor to suits or proceedings begun at the time of the passage of this Act.

SEC. 1321. (a) That the Act entitled "An Act to limit the time within which prosecutions may be instituted against persons charged with violating internal-revenue laws," approved July 5, 1884, is amended to read as follows:

"That no person shall be prosecuted, tried, or punished for any of the various offenses arising under the internal-revenue laws of the United States unless the indictment is found or the information instituted within three years next after the commission of the offense: *Provided,* That the time during which the person committing the offense is absent from the district wherein the same is committed shall not be taken as any part of the time limited by law for the commencement of such proceedings: *Provided further,* That the provisions of this Act shall not apply to offenses committed prior to its passage: *Provided further,* That where a complaint shall be instituted before a commissioner of the United States within the period above limited, the time shall be extended until the discharge of the grand jury at its next session within the district: *And provided further,* That this Act shall not apply to offenses committed by officers of the United States."

(b) Any prosecution or proceeding under an indictment found or information instituted prior to the passage of this Act shall not be affected in any manner by this amendment, but such prosecution or proceeding shall be subject to the limitations imposed by law prior to the passage of this Act.

ASSESSMENTS

SEC. 1322. That all internal revenue taxes, except as provided in section 250 of this Act, shall, notwithstanding the provisions of section 3182 of the Revised Statutes or any other

provision of law, be assessed within four years after such taxes became due, but in the case of fraud with intent to evade tax or willful attempt in any manner to defeat or evade tax, such tax may be assessed at any time.

FRAUDULENT RETURNS

SEC. 1323. That section 3225 of the Revised Statutes of the United States, as amended, is reenacted without change as follows:

"SEC. 3225. When a second assessment is made in case of any list, statement, or return, which in the opinion of the collector or deputy collector was false or fraudulent, or contained any understatement or undervaluation, such assessment shall not be remitted, nor shall taxes collected under such assessment be refunded, or paid back, or recovered by any suit, unless it is proved that such list, statement, or return was not willfully false or fraudulent and did not contain any willful understatement or undervaluation."

INTEREST ON REFUNDS AND JUDGMENTS

SEC. 1324. (a) That upon the allowance of a claim for the refund of or credit for internal revenue taxes paid, interest shall be allowed and paid upon the total amount of such refund or credit at the rate of one-half of 1 per centum per month to the date of such allowance, as follows: (1) if such amount was paid under a specific protest setting forth in detail the basis of and reasons for such protest, from the time when such tax was paid, or (2) if such amount was not paid under protest but pursuant to an additional assessment, from the time such additional assessment was paid, or (3) if no protest was made and the tax was not paid pursuant to an additional assessment, from six months after the date of filing of such claim for refund or credit. The term "additional assessment" as used in this section means a further assessment for a tax of the same character previously paid in part.

(b) Section 177 of the Judicial Code is amended to read as follows:

"SEC. 177. No interest shall be allowed on any claim up to the time of the rendition of judgment by the Court of Claims, unless upon a contract expressly stipulating for the payment of interest, except that interest may be allowed in any judgment of any court rendered after the passage of the Revenue Act of 1921 against the United States for any internal-revenue tax erroneously or illegally assessed or collected, or for any penalty collected without authority or any sum which was excessive or in any manner wrongfully collected, under the internal-revenue laws."

PAYMENT OF TAXES BY CHECK OR UNITED STATES SECURITIES

SEC. 1325. That collectors may receive, at par with an adjustment for accrued interest, notes or certificates of indebtedness issued by the United States and uncertified checks in payment of income, war-profits and excess-profits taxes and any other taxes payable other than by stamp, during such time and under such regulations as the Commissioner, with the approval of the Secretary, shall prescribe; but if a check so received is not paid by the bank on which it is drawn the person by whom such check has been tendered shall remain liable for the payment of the tax and for all legal penalties and additions the same as if such check had not been tendered.

FRAUDS ON PURCHASES

SEC. 1326. That whoever in connection with the sale or lease, or offer for sale or lease, of any article, or for the purpose of making such sale or lease, makes any statement, written or oral, (1) intended or calculated to lead any person to believe that any part of the price at which such article is sold or leased, or offered for sale or lease, consists of a tax imposed under the authority of the United States, or (2) ascribing a particular part of such price to a tax imposed under the authority of the United States, knowing that such statement is false or that the tax is not so great as the portion of such price ascribed to such tax, shall be guilty of a misdemeanor and upon conviction

thereof shall be punished by a fine of not more than $1,000 or by imprisonment not exceeding one year, or both.

TAX SIMPLIFICATION BOARD

SEC. 1327. (a) That there is hereby established in the Department of the Treasury a board to be known as the "Tax Simplification Board" (hereinafter in this section called the "Board"), to be composed as follows:

(1) Three members who shall represent the public, to be appointed by the President; and

(2) Three members who shall represent the Bureau of Internal Revenue and shall be officers or employees of the United States serving in such Bureau, to be appointed by the Secretary.

(b) Any vacancy in the Board shall be filled in the same manner as the original appointment. The members representing the public shall serve without compensation except reimbursement for traveling, subsistence, and other necessary expenses incurred in the performance of the duties vested in them by this section. The members representing the Bureau of Internal Revenue shall serve without compensation in addition to that received for their service in such Bureau.

(c) The Secretary shall furnish the Board with such clerical assistance, quarters and stationery, furniture, office equipment, and other supplies as may be necessary for the performance of the duties vested in them by this section.

(d) It shall be the duty of the Board to investigate the procedure of and the forms used by the Bureau in the administration of the internal revenue laws, and to make recommendations in respect to the simplification thereof. The Board shall make a report to the Congress on or before the first Monday of December in each year.

(e) The expenditures of the Board shall be paid upon vouchers approved by the board and signed by the chairman thereof. For the expenditures of the Board for the fiscal year ending June, 30, 1922, there is authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of $10,000.

(f) The Board shall cease to exist on December 31, 1924. *Illustrated in Problem:*

CONSOLIDATION OF LIBERTY BOND TAX EXEMPTIONS

SEC. 1328. That the various Acts authorizing the issues of Liberty bonds are amended and supplemented as follows: 72

(a) On and after January 1, 1921, 4 per centum and 4¼ per centum Liberty bonds shall be exempt from graduated additional income taxes, commonly known as surtaxes, and excess-profits and war-profits taxes, now or hereafter imposed by the United States upon the income or profits of individuals, partnerships, corporations, or associations, in respect to the interest on aggregate principal amounts thereof as follows:

Until the expiration of two years after the date of the termination of the war between the United States and the German Government, as fixed by proclamation of the President, on $125,000 aggregate principal amount; and for three years more on $50,000 aggregate principal amount.

(b) The exemptions provided in subdivision (a) shall be in addition to the exemptions provided in section 7 of the Second Liberty Bond Act, and in addition to the exemption provided in subdivision (3) of section 1 of the Supplement to the Second Liberty Bond Act in respect to bonds issued upon conversion of 3½ per centum bonds, but shall be in lieu of the exemptions provided and free from the conditions and limitations imposed in subdivisions (1) and (2) of section 1 of the Supplement to Second Liberty Bond Act and in section 2 of the Victory Liberty Loan Act.

DEPOSIT OF UNITED STATES BONDS OR NOTES IN LIEU OF SURETY

SEC. 1329. That wherever by the laws of the United States or regulations made pursuant thereto, any person is required to furnish any recognizance, stipulation, bond, guaranty, or undertaking, hereinafter called "penal bond," with surety or sureties, such person may, in lieu of such surety or sureties, deposit as security with the official having authority to approve such penal bond, United States Liberty bonds or other bonds or notes of the United States in a sum equal at their par

value to the amount of such penal bond required to be furnished, together with an agreement authorizing such official to collect or sell such bonds or notes so deposited in case of any default in the performance of any of the conditions or stipulations of such penal bonds. The acceptance of such United States bonds or notes in lieu of surety or sureties required by law shall have the same force and effect as individual or corporate sureties, or certified checks, bank drafts, post-office money orders, or cash, for the penalty or amount of such penal bond. The bonds or notes deposited hereunder and such other United States bonds or notes as may be substituted therefor from time to time as such security, may be deposited with the Treasurer of the United States, a Federal reserve bank, or other depositary duly designated for that purpose by the Secretary, which shall issue receipt therefor, describing such bonds or notes so deposited. As soon as security for the performance of such penal bond is no longer necessary, such bonds or notes so deposited, shall be returned to the depositor: *Provided,* That in case a person or persons supplying a contractor with labor or material as provided by the Act of Congress, approved February 24, 1905 (33 Stat. 811), entitled "An Act to amend an Act approved August thirteenth, eighteen hundred and ninety-four, entitled 'an Act for the protection of persons furnishing materials and labor for the construction of public works,' " shall file with the obligee, at any time after a default in the performance of any contract subject to said Acts, the application and affidavit therein provided, the obligee shall not deliver to the obligor the deposited bonds or notes nor any surplus proceeds thereof until the expiration of the time limited by said Acts for the institution of suit by such person or persons, and, in case suit shall be instituted within such time, shall hold said bonds or notes or proceeds subject to the order of the court having jurisdiction thereof: *Provided further,* That nothing herein contained shall affect or impair the priority of the claim of the United States against the bonds or notes deposited or any right or remedy granted by said Acts or by this section to the United

States for default upon any obligation of said penal bond: *Provided further,* That all laws inconsistent with this section are hereby so modified as to conform to the provisions hereof; *And provided further,* That nothing contained herein shall affect the authority of courts over the security, where such bonds are taken as security in judicial proceedings, or the authority of any administrative officer of the United States to receive United States bonds for security in cases authorized by existing laws. The Secretary may prescribe rules and regulations necessary and proper for carrying this section into effect.

CONSOLIDATED RETURNS FOR YEAR 1917

SEC. 1331. (a) That Title II of the Revenue Act of 1917 shall be construed to impose the taxes therein mentioned upon the basis of consolidated returns of net income and invested capital in the case of domestic corporation and domestic partnerships that were affiliated during the calendar year 1917.

(b) For the purpose of this section a corporation or partnership was affiliated with one or more corporations or partnerships (1) when such corporation or partnership owned directly or controlled through closely affiliated interests or by a nominee or nominees all or substantially all the stock of the other or others, or (2) when substantially all the stock of two or more corporations or the business of two or more partnerships was owned by the same interests: *Provided,* That such corporations or partnerships were engaged in the same or a closely related business, or one corporation or partnership bought from or sold to another corporation or partnership products or services at prices above or below the current market, thus effecting an artificial distribution of profits, or one corporation or partnership in any way so arranged its financial relationships with another corporation or partnership as to assign to it a disproportionate share of net income or invested capital. For the purposes of this section, public service corporations which (1) were operated independently, (2) were not physically connected or merged and (3) did not receive special permission to make a consolidated return, shall not be construed to have

been affiliated; but a railroad or other public utility which was owned by an industrial corporation and was operated as a plant facility or as an integral part of a group organization of affiliated corporations which were required to file a consolidated return, shall be construed to have been affiliated.

(c) The provisions of this section are declaratory of the provisions of Title II of the Revenue Act of 1917.

ALTERNATIVE TAX ON PERSONAL SERVICE CORPORATIONS

SEC. 1332. (a) That if either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is by final adjudication declared invalid, there shall, in addition to all other taxes, be levied, collected, and paid on the net income (as defined in section 232) received during the calendar years 1918, 1919, 1920, and 1921, by every personal service corporation (as defined in section 200) included within the provisions of such subdivisions, a tax equal to the taxes imposed by Titles II and III of the Revenue Act of 1918 and, in the case of income received during the calendar year 1921, by Titles II and III of this Act.

(b) In such event every such personal service corporation shall, on or before the fifteenth day of the sixth month following the date of entry of decree upon such final adjudication, make a return of any income received during each of the calendar years 1918, 1919, 1920, and 1921 in the manner prescribed by the Revenue Act of 1918 (or in the manner prescribed by this Act, in the case of income received during the calendar year 1921). Such return shall be made and the net income shall be computed on the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in the manner provided for other corporations under the Revenue Act of 1918 and this Act.

(c) If either subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act is so declared invalid, claims for credit or refund of taxes paid under both such sections shall be allowed, if made within the time provided in subdivision (f) of this section.

(d) In case the claims for credit or refund, filed within six months from such date of entry of decree, represent less than 30 per centum of the outstanding stock or shares in the corporation, the amount of taxes imposed by this section upon such corporation shall be reduced to that proportion thereof which the number of stock or shares owned by the shareholders or members making such claim bears to the total number of stock or shares outstanding.

(e) The tax imposed by this section shall be assessed, collected, and paid upon the same basis, in the same manner, and subject to the same provisions of law, including penalties, as the taxes imposed by sections 230 and 301 of the Revenue Act of 1918 (or by sections 230 and 301 of this Act, in the case of income received during the calendar year 1921), but no interest or penalties shall be due or payable thereon for any period prior to the date upon which the return is by this section required to be made and the first installment paid. The amount of tax paid by any shareholder or member of a personal service corporation pursuant to the provisions of subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act shall be credited against the tax due from such corporation under this section upon the joint written application of such corporation and such shareholder or member or his representatives, heirs, or assigns, if such application is filed with the Commissioner within six months from such date of entry of decree.

(f) Notwithstanding any other provision of law, no claim for a credit or refund of taxes paid under subdivision (e) of section 218 of the Revenue Act of 1918 or subdivision (d) of section 218 of this Act, may be filed after the expiration of six months from such date of entry of decree: *Provided, however,* That a personal service corporation of which no shareholder or member has filed such claim within such period of six months shall not be subject to the tax imposed by this section.

TITLE XIV.—GENERAL PROVISIONS

REPEALS

SEC. 1400. (a) That the following parts of the Revenue Act of 1918 are repealed, to take effect (except as otherwise provided in this Act) on January 1, 1922, subject to the limitations provided in subdivision (b):

Title II (called "Income Tax") as of January 1, 1921;

Title III (called "War-Profits and Excess-Profits Tax") as of January 1, 1921; . . . and

Sections 1314, 1315, 1316, 1317, 1319, and 1320 of Title XIII (being certain administrative provisions) on the passage of this Act.

(b) The parts of the Revenue Act of 1918 which are repealed by this Act shall (unless otherwise specifically provided in this Act) remain in force for the assessment and collection of all taxes which have accrued under the Revenue Act of 1918 at the time such parts cease to be in effect, and for the imposition and collection of all penalties or forfeitures which have accrued or may accrue in relation to any such taxes. In the case of any tax imposed by any part of the Revenue Act of 1918 repealed by this Act, if there is a tax imposed by this Act in lieu thereof, the provision imposing such tax shall remain in force until the corresponding tax under this Act takes effect under the provisions of this Act. The unexpended balance of any appropriation heretofore made and now available for the administration of any such part of the Revenue Act of 1918 shall be available for the administration of this Act or the corresponding provision thereof.

SAVING CLAUSE IN EVENT OF UNCONSTITUTIONALITY

SEC. 1403. That if any provision of this Act, or the application thereof to any person or circumstances, is held invalid, the remainder of the Act, and the application of such provision to other persons or circumstances, shall not be affected thereby.

EFFECTIVE DATE OF ACT

SEC. 1404. That except as otherwise provided, this Act shall take effect upon its passage.

Approved, November 23, 1921, at 3.55 p. m.

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